1981–82 MISCELLANEOUS TAX BILLS, X

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 425, S. 608, S. 1348, S. 1479, S. 1580, and S. 1656

OCTOBER 16, 1981

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1981-82 MISCELLANEOUS TAX BILLS, X

FRIDAY, OCTOBER 16, 1981

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:23 a.m. in room 2221, Dirksen Senate Office Building, Hon. Bob Packwood (chairman of the subcommittee) presiding.

Present: Senators Packwood, Long, Durenberger, and Bradley.

Senator PACKWOOD. The hearing will come to order. We will start our hearing this morning with Senator Hatfield, the senior Senator from the State of Oregon.

[The committee press release; the bills S. 425, S. 608, S. 1348, S. 1479, S. 1580 and S. 1656; the Joint Committee on Taxation's description and Senators Baucus' and Levin's prepared statements follow:]

PRESS RELEASE

FOR IMMEDIATE RELEASE
September 28, 1981

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Taxation
and Debt Management
2227 Dirksen Senate Office Bldg.

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON SIX MISCELLANEOUS TAX BILLS

Senator Bob Packwood, Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, announced today that the Subcommittee will hold a hearing on October 16, 1981, on six miscellaneous tax bills.

The hearing will begin at 9:30 a.m. in Room 2221 of the Dirksen Senate Office Building.

The following legislative proposals will be considered at the hearing:

S.425 --Introduced by Senator Packwood. S. 425 would exempt from the coverage of the Mortgage Subsidy Bond Tax Act of 1980 certain general obligation mortgage bond issues of the State of Oregon.

S.608 -- Introduced by Senator Baucus. S. 608 would allow individuals a deduction for certain expenses paid or incurred in connection with the adoption of a child.

S.1348 -- Introduced by Senator Sasser. S. 1348 would amend or clarify certain provisions of the Mortgage Subsidy Bond Tax Act of 1980 to facilitate the issuance and marketing of tax-exempt mortgage subsidy bonds.

S.1479 -- Introduced by Senator Metzenbaum. S. 1479 would exclude from income certain adoption expenses paid by an employer and provide a deduction for certain adoption expenses paid by an individual.

S.1580 -- Introduced by Senator Jepsen. S. 1580 would provide a personal exemption for childbirth or adoption and permit the taxpayer to choose a deduction or tax credit for certain adoption expenses.

S.1656 -- Introduced by Senator Durenberger. S. 1656 would amend or clarify certain provisions of the Mortgage Subsidy Bond Tax Act of 1980 to facilitate the issuance and marketing of tax-exempt mortgage subsidy bonds.

II

97TH CONGRESS
1ST SESSION

S. 425

To amend the Mortgage Subsidy Bond Tax Act of 1980 to exempt from the coverage of such Act certain general obligation mortgage bond issues of the State of Oregon.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 5 (legislative day, JANUARY 5), 1981

Mr. PACKWOOD (for himself and Mr. HATFIELD) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Mortgage Subsidy Bond Tax Act of 1980 to exempt from the coverage of such Act certain general obligation mortgage bond issues of the State of Oregon.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) the table set forth in section 1104(n)(1) of the Mortgage Subsidy Bond Tax Act of 1980 is amended by adding at the end of the table the following item:

"State of Oregon	500,000,000	January 7, 1981, and April, 1981, General Obligation Bond issues of the State of Oregon for financing for veterans qualified under the Oregon Department of Veterans' Affairs program."

(b) The heading for the table set forth in section 1104(n)(1) of such Act is amended by striking out "city or county" and inserting in lieu thereof "state, city, or county".

SEC. 2. The amendment made by this Act shall take effect as if included in the amendments made by the Mortgage Subsidy Bond Tax Act of 1980.

○

II

97TH CONGRESS
1ST SESSION

S. 608

To amend the Internal Revenue Code of 1954 to allow individuals a deduction for certain expenses paid or incurred in connection with the adoption of a child.

IN THE SENATE OF THE UNITED STATES

MARCH 3 (legislative day, FEBRUARY 16), 1981

Mr. BAUCUS introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to allow individuals a deduction for certain expenses paid or incurred in connection with the adoption of a child.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) part VII of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to additional itemized deductions for individuals) is amended by redesignating section 221 as section 222 and by inserting after section 220 the following new section:

"SEC. 221. ADOPTION EXPENSES.

"(a) Allowance of Deduction.—In the case of an individual, there shall be allowed as a deduction the amount of the adoption expenses paid or incurred by the taxpayer during the taxable year.

"(b) Adoption Expenses Defined.—For purposes of this section, the term 'adoption expenses' means reasonable and necessary adoption agency fees, court costs, attorney fees, and other expenses which are directly related to the legal adoption of a child by the taxpayer when said adoption has been arranged by a public welfare department (or similar State or local public social service agency with legal responsibility for child placement) or by a not-for-profit voluntary adoption agency authorized or otherwise licensed by the State or local government to place children for adoption and when said adoption expenses are not incurred in violation of State or Federal law.

"(c) Denial of Double Benefit.—No amount which is taken into account in computing a deduction or credit under any other provision of this chapter shall be allowed as a deduction under this section.".

(b) Section 62 of such Code (defining adjusted gross income) is amended by inserting after paragraph (16) the following new paragraph:

"(17) Adoption expenses.—The deduction allowed by section 221.".

(c) The table of sections for such part VII is amended by striking out the item relating to section 221 and inserting in lieu thereof the following:

"Sec. 221. Adoption expenses.
"Sec. 222. Cross references.".

(d) The amendments made by this Act shall apply to taxable years beginning after December 31, 1981.

○

II

97TH CONGRESS
1ST SESSION

S. 1348

To amend the Internal Revenue Code of 1954 to clarify certain requirements which apply to mortgage subsidy bonds.

IN THE SENATE OF THE UNITED STATES

JUNE 9 (legislative day, JUNE 1), 1981

Mr. SASSER (for himself, Mr. BAKER, Mr. BUMPERS, Mr. PRYOR, Mr. PACKWOOD, and Mr. PELL) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to clarify certain requirements which apply to mortgage subsidy bonds.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. REQUIREMENTS FOR MORTGAGE SUBSIDY BONDS.

(a) GOOD FAITH.—Subparagraph (B) of section 103A(c)(2) of the Internal Revenue Code of 1954 (relating to mortgage eligibility requirements) is amended to read as follows:

"(B) GOOD FAITH EFFORT TO COMPLY WITH MORTGAGE ELIGIBILITY REQUIRE-

MENTS.—An issue which fails to meet one or more of the requirements of subsections (d), (e), and (f) and paragraphs (2) and (3) of subsection (j) shall be treated as meeting such requirements if—

"(i) the issuer in good faith attempted to meet all such requirements before the mortgages were executed, and

"(ii) any failure to meet the requirements of such subsection and paragraphs is corrected within a reasonable period after such failure is first discovered."

(b) RELIANCE ON COVENANT.—Paragraph (2) of section 103A(c) of such Code is amended by adding at the end thereof the following new subparagraph:

"(D) COVENANT AS TO COMPLIANCE.—For purposes of this subsection, unless the Secretary has published notice of an issuer's failure to comply prior to the sale of a qualified mortgage issue, a covenant by and issuer as to its good faith compliance with the requirement of subsections (d), (e), (f), (g), (h), (i), (j), (k), and (l) subsequent to the date of issuance may be relied on by the holder of any obligation which is a part of any issue which was a qualified mortgage issue as of its issue date."

(c) OWNERSHIP INTEREST.—Paragraph (1) of section 103A(e) of such Code (relating to prior residency requirements for mortgagors) is amended to read as follows:

"(1) IN GENERAL.—An issue meets the requirements of this subsection only if each mortgagor to whom financing is provided under the issue certifies as to the fact that such mortgagor either (A) had an ownership interest in a prior residence which an appropriate State or local official has certified does not meet the minimum property standards established for the areas by the State or local government with respect to sanitation, heating, major structural deficiencies or overcrowding, (B) had an ownership interest in a prior residence which can no longer continue to be occupied on a permanent basis due to natural disaster or governmental action, or (C) had a present ownership interest in a principal residence of such mortgagor at no time during the 3-year period ending on the date the mortgage is executed. For purposes of the preceding sentence, the mortgagor's interest in the residence with respect to which the financing is being provided shall not be taken into account."

(d) PURCHASE PRICE REQUIREMENTS.—Paragraphs (2) and (3) of section 103A(f) of such Code (relating to purchase price requirements for residences financed with proceeds of a qualified mortgage issue) are amended to read as follows:

"(2) AVERAGE AREA PURCHASE PRICE.—For purposes of paragraph (1), the term 'average area purchase price' means, with respect to any residence, the average purchase price of single family residences (in the statistical area in which the residence is located) which were purchased during the most recent 12-month period for which sufficient statistical information is available. The determination under the preceding sentence shall be made as of the date on which the commitment to provide the financing is made (or, if earlier, the date of the purchase of the residence). An issuer shall not be required to compute such average area purchase price more than twice during any 12-month period.

"(3) SEPARATE APPLICATION TO NEW RESIDENCES AND OLD RESIDENCES.—For purposes of this subsection, the determination of average area purchase price need not include residences which are not typically financed through a normal real estate mortgage loan (such as a residence to be located on land occupied under a lease having a term less than 15 years or a residence which is normally financed as personal property) and may be made separately with respect to—

"(A) residences which have not been previously occupied, and

"(B) residences which have been previously occupied."

(e) EFFECTIVE MORTGAGE RATE.—Subparagraph (A) of section 103A(i)(2) of such Code (relating to the effective rate of interest on mortgages made from the proceeds of a qualified mortgage issue) is amended to read as follows:

"(A) IN GENERAL.—An issue shall be treated as meeting the requirements of this paragraph only if the excess of—

"(i) the effective rate of interest on the mortgages provided under the issue, over

"(ii) the yield on the issue,

is not greater than 1½ percentage points."

(f) YIELD COMPUTATIONS.—

(1) Clause (iv) of section 103A(i)(2)(B) of such Code (relating to the effective rate of mortgage interest) is amended to read as follows:

"(iv) PREPAYMENT ASSUMPTION.—In determining the effective rate of interest, it shall be assumed that the mortgage prepayment rate will be the rate set forth in the most recent mortgage maturity experience table published by the Federal Housing Administration for the State (or, if available, the area within the State) in which the residences are located."

(2) Subparagraph (C) of section 103A(i)(2) of such Code is amended to read as follows:

"(C) YIELD ON THE ISSUE.—For purposes of this subsection, the yield on the issue shall be determined on the basis of—

"(i) the issue price (within the meaning of section 1232(b)(2)), and

"(ii) expected maturities for the bonds which are consistent with the assumption required under subparagraph (B)(iv) and the expected use of such funds to pay or redeem bonds or finance additional mortgages."

(g) RESERVE INVESTMENTS.—Paragraph (3) of section 103A(i) of such Code (relating to nonmortgage investments) is amended—

(1) by striking out subparagraph (B) and inserting in lieu thereof the following:

"(B) EXCEPTION FOR TEMPORARY PERIODS.—Subparagraph (A) shall not apply to—

"(i) proceeds of the issue invested for a temporary period until such proceeds are needed for mortgages, and

"(ii) temporary investment periods related to debt service.", and

(2) by adding at the end thereof the following new subparagraph:

"(D) LOSS NOT REQUIRED.—Nothing in this paragraph shall require the disposition of any investment in such manner or at such time as will result in a loss which is in excess of the amount which would otherwise be available at such time to be paid or credited to mortgagors as provided in paragraph (4)(A)."

(h) PROGRAM COMPLIANCE.—Subsection (i) of section 103A of such Code (relating to arbitrage requirements of qualified mortgage issues) is amended by adding at the end thereof the following new paragraph:

"(6) PROGRAM COMPLIANCE.—

"(A) ISSUES COMBINED.—Two or more qualified mortgage issues of a single issuer may be treated as a single issue for purposes of determining compliance with this subsection. In such event the yield on the included issues and on the related mortgage and nonmortgage investments shall be computed on a joint basis.

"(B) Reserves against losses.—In determining the amount of earnings or income derived from nonmortgage investments, the cost of funding and maintaining a reasonable reserve against losses on investments may be taken into account. A modified cash or accrual basis of accounting may be adopted for such purposes as to both mortgage and nonmortgage investments.

"(C) Credits.—An issuer may, in its discretion, allocate such credits or payments between persons eligible therefor with respect to any qualified mortgage issue at the time such amounts were received or at the time of distribution and change the basis for any such allocation from time to time."

(i) Mortgage Assumptions.—Paragraph (3) of section 103A(j) of such Code (relating to restrictions on assumptions of mortgages financed with the proceeds of a qualified mortgage issue) is amended to read as follows:

"(3) Certain requirements must be met where mortgage is assumed.—An issue meets the requirements of this subsection only if a mortgage with respect to which owner-financing has been provided under such issue may be assumed only if the requirements of subsections (d), (e), and (f), are met with respect to such assumption. The requirements of such subsections need not be met, however, in connection with the assumption of any mortgage which is insured by the Federal Housing Administration or guaranteed by the Veterans' Administration."

(j) ENERGY IMPACTED AREAS.—Paragraph (1) of section 103A(k) of such Code (relating to targeted area residences) is amended by striking out "or" at the end of subparagraph (A), by striking out the period at the end of subparagraph (B) and inserting in lieu thereof ", or", and by adding at the end thereof the following new subparagraph:

"(C) an area designated as impacted by increased production of coal, uranium, oil, gas, or other energy-related materials which meets the criteria set forth in section 601(a) of the Powerplant and Industrial Fuel Use Act of 1978 with respect to areas impacted by increased coal or uranium production."

(k) TARGETED AREAS.—Paragraph (3) of section 103A(k) of such Code is amended to read as follows:

"(3) AREA OF CHRONIC ECONOMIC DISTRESS.—For purposes of paragraph (1), the term 'area of chronic economic distress' means an area of chronic economic distress designated by the State as meeting the standards established by the State for purposes of this subsection, provided that areas of chronic economic distress may not exceed 25 percent of the geographic area within the State."

(l) STATISTICAL AREAS.—Paragraph (4) of section 103A(l) of such Code (defining statistical area) is amended by adding at the end thereof the following new subparagraph:

"(E) COMBINED AREAS.—To the extent applied consistently with respect to a qualified mortgage issue, the term 'statistical area' may mean two or more other statistical areas treated on a combined basis."

(m) REPEAL OF REGISTRATION REQUIREMENTS.—

(1) AMENDMENT OF SECTION 103A.—

(A) Paragraph (1) of section 103A(j) of such Code is hereby repealed.

(B) Subparagraph (C) of section 103A(c)(2) of such Code is amended by striking out ", and paragraph (1) of subsection (j)".

(2) AMENDMENT OF SECTION 103(b).—Subparagraph (A) of section 103(b)(4) of such Code is amended by striking out "if each obligation issued pursuant to the issue is in registered form and".

SEC. 2. EFFECTIVE DATE.

The amendments made by this Act shall take effect as if included in the amendments made by the Mortgage Subsidy Bond Tax Act of 1980.

○

II

97TH CONGRESS
1ST SESSION

S. 1479

To amend the Internal Revenue Code of 1954 to exclude from the income of an employee certain adoption expenses paid by an employer, to provide a deduction for adoption expenses paid by an individual, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JULY 14 (legislative day, JULY 8), 1981

Mr. METZENBAUM (for himself, Mr. TSONGAS, and Mr. WILLIAMS) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to exclude from the income of an employee certain adoption expenses paid by an employer, to provide a deduction for adoption expenses paid by an individual, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. EXCLUSION FROM THE INCOME OF AN EMPLOYEE OF ANY BENEFITS RECEIVED FROM, OR CONTRIBUTIONS OF AN EMPLOYER TO, AN ADOPTION EXPENSE PLAN.

(a) EXCLUSION FROM INCOME.—Subsection (b) of section 105 of the Internal Revenue Code of 1954 (relating to amounts received under accident and health plans) is amended to read as follows:

"(b) MEDICAL CARE AND ADOPTION EXPENSES.—Except in the case of amounts received by a taxpayer attributable to, and not in excess of, deductions allowed under section 213 (relating to medical, etc., expenses) or section 221 (relating to adoption expenses) for any prior taxable year, gross income does not include—

"(1) amounts referred to in subsection (a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care (as defined in section 213(c)(1)) of the taxpayer, his spouse, and his dependents (as defined in section 152), or

"(2) amounts—

"(A) received by an employee under an adoption expense plan, or

"(B) contributed by an employer on behalf of an employee to an adoption expense plan.".

(b) Discriminatory Plans.—Subsection (h) of section 105 of such Code (relating to amounts paid under a discriminatory self-insured medical expense reimbursement plan) is amended—

(1) by striking out "self-insured medical reimbursement plan" each place it appears and inserting in lieu thereof "self-insured reimbursement plan",

(2) by inserting "or adoption benefits" after "health benefits" in clause (iv) of paragraph (3)(B), and

(3) by striking out "Self-Insured Medical Expense Reimbursement Plan" in the caption and inserting in lieu thereof "Self-Insured Reimbursement Plan".

(c) Definition of Self-Insured Reimbursement Plan.—Paragraph (6) of section 105(h) of such Code is amended to read as follows:

"(6) Self-insured reimbursement plan.—For purposes of this section, the term 'self-insured reimbursement plan' means—

"(A) a plan of an employer to reimburse employees for expenses referred to in subsection (b)(1) for which reimbursement is not provided under a policy of accident and health insurance, or

"(B) an adoption expense plan.".

(d) DEFINITION OF ADOPTION EXPENSE PLAN.—Section 105 of such Code is amended by adding at the end thereof of the following new subsection:

"(i) ADOPTION EXPENSE PLAN.—For purposes of this section, an adoption expense plan is a written plan of an employer to reimburse employees for adoption expenses (as defined in section 221(b)) incurred by such employees.".

(e) CONFORMING AMENDMENTS.—

(1) The heading of section 105 of such Code is amended by inserting "; ADOPTION EXPENSE PLANS" after "PLANS".

(2) The table of sections for part III of subchapter B of chapter 1 of such Code is amended by inserting "; adoption expense plans" after "plans" in the item relating to section 105.

(3) Paragraph (20) of section 3401(a) of such Code (relating to the collection of income tax at source) is amended—

(A) by striking out "medical care", and

(B) by striking out "self-insured medical reimbursement plan" and inserting in lieu thereof "self-insured reimbursement plan".

SEC. 2. DEDUCTION FOR ADOPTION EXPENSES PAID BY AN INDIVIDUAL.

(a) IN GENERAL.—Part VII of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to additional itemized deductions for individuals) is amended by redesignating section 221 as section 222 and by inserting after section 220 the following new section:

"SEC. 221. ADOPTION EXPENSES.

"(a) ALLOWANCE OF DEDUCTION.—In the case of an individual, there shall be allowed as a deduction the amount of the adoption expenses, not compensated by insurance or otherwise, paid or incurred by the taxpayer during the taxable year.

"(b) ADOPTION EXPENSES DEFINED.—For purposes of this section, the term 'adoption expenses' means reasonable and necessary expenses incurred which are directly related to the legal adoption of a child by the taxpayer, including, but not limited to, legal fees, medical expenses, adoption fees, temporary foster care expenses, transportation costs, or expenses related to the pregnancy of the natural mother of such child, when said adoption has been arranged by a public welfare department (or similar State or local public social service agency with legal responsibility for child placement) or by a not-for-profit voluntary adoption agency authorized or otherwise licensed by the State or local government to place children for adoption and when said adoption expenses are not incurred in violation of State or Federal law.

"(c) DENIAL OF DOUBLE BENEFIT.—No amount which is taken into account in computing a deduction or credit under any other provision of this chapter shall be allowed as a deduction under this section.".

(b) ADJUSTED GROSS INCOME.—Section 62 of such Code (defining adjusted gross income) is amended by inserting after paragraph (16) the following new paragraph:

"(17) ADOPTION EXPENSES.—The deduction allowed by section 221.".

(c) CONFORMING AMENDMENT.—The table of sections for such part VII is amended by striking out the item relating to section 221 and inserting in lieu thereof the following:

"Sec. 221. Adoption expenses.
"Sec. 222. Cross references.".

SEC. 3. EMPLOYER CONTRIBUTION TO ADOPTION EXPENSE PLAN TREATED AS AN ORDINARY AND NECESSARY BUSINESS EXPENSE.

Section 162 of the Internal Revenue Code of 1954 (relating to trade or business expenses) is amended by redesignating subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection:

"(h) CONTRIBUTIONS TO ADOPTION EXPENSE PLAN.—For purposes of subsection (a), any contribution made by an employer to an adoption expense plan (as defined in section 105(i)) for, or on behalf of, an employee shall be treated as an ordinary and necessary expense incurred in carrying on a trade or business.".

SEC. 4. EFFECTIVE DATE.

The amendments made by this Act shall apply to taxable years beginning after December 31, 1980.

○

II

97TH CONGRESS
1ST SESSION

S. 1580

To amend the Internal Revenue Code of 1954 to provide a personal exemption for childbirth or adoption and to permit the taxpayer to choose a deduction or a tax credit for adoption expenses.

IN THE SENATE OF THE UNITED STATES

JULY 31 (legislative day, JULY 8), 1981

Mr. JEPSEN introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide a personal exemption for childbirth or adoption and to permit the taxpayer to choose a deduction or a tax credit for adoption expenses.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. EXEMPTIONS FOR CHILDBIRTH OR ADOPTION.

(a) IN GENERAL.— Section 151 of the Internal Revenue Code of 1954 (relating to allowance of deductions for personal exemptions) is amended by adding at the end thereof the following new subsection:

"(f) Additional Exemption for Childbirth or Adoption.—

"(1) In general.—An exemption of $1,000 for each child born to, or adopted by, the taxpayer during the taxable year.

"(2) Birth and adoption of certain children.—In the case of—

"(A) a child who is born to the taxpayer and who is handicapped (within the meaning of section 190(b)(3)), or

"(B) the adoption of a child—

"(i) who is a member of a minority race on ethnic group, or

"(ii) who has attained the age of 6 before the beginning of the taxable year for which the additional exemption allowed by paragraph (1) is claimed, or

"(iii) who is handicapped (within the meaning of section 190(b)(3)),

'$3,000' shall be substituted for '$1,000' in paragraph (1).

"(3) Joint return.—The additional exemption allowed by paragraph (1) for any taxable year shall not be allowed to an individual who is not a married individual (as defined in section 143) or to a married individual (as defined in such section) who does not make a joint return of tax with his spouse for the taxable year.

"(4) Carryover of unused deduction.—In the case of a taxpayer for whom the exemption allowed by paragraph (1) for a taxable year reduces his tax liability to zero, and in the case of a taxpayer whose liability for tax under this chapter (determined without regard to the additional exemption allowed by paragraph (1)) is zero, the additional exemption allowed by paragraph (1) for that taxable year, or that portion of such exemption which is properly attributable to a reduction of the taxpayer's liability for tax under this chapter below zero, shall be carried over to the following taxable year and shall be treated, for such following taxable year, as an additional exemption allowed by paragraph (1) for that taxable year.".

(b) Effective Date.—The amendment made by this section shall apply with respect to taxable years beginning after December 31, 1980.

SEC. 2. ADOPTION EXPENSES.

(a) Deduction.—

(1) In general.—Part VII of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to additional itemized deductions for individuals) is

amended by redesignating section 221 as section 222 and by inserting after section 220 the following new section:

"SEC. 221. ADOPTION EXPENSES.

"(a) ALLOWANCE OF DEDUCTION.—In the case of an individual, there shall be allowed as a deduction the amount of the adoption expenses paid or incurred by the taxpayer during the taxable year.

"(b) LIMITATION ON DEDUCTIONS.—

"(1) MINIMUM DOLLAR AMOUNT.—No deduction shall be allowable under subsection (a) for the first $500 of adoption expenses paid or incurred with respect to the adoption of any child.

"(2) MAXIMUM DOLLAR AMOUNT.—The aggregate amount allowable as a deduction under subsection (a) for all taxable years with respect to the adoption of any child shall not exceed $3,500 ($4,500 in the case of an international adoption).

"(3) DENIAL OF DOUBLE BENEFIT.—

"(A) IN GENERAL.—No deduction shall be allowable under subsection (a) for any amount for which a deduction or credit (other than the credit allowable under section 44F (relating to adoption expenses)) is allowable under any other provision of this chapter.

"(B) Grants.—No deduction shall be allowable under subsection (a) for any adoption expense paid from any funds received under any Federal, State, or local program.

"(C) Election to take credit in lieu of deduction.—This section shall not apply in the case of a taxpayer who, for the taxable year, elects to take the credit against tax provided by section 44F (relating to adoption expenses). The election shall be made in such manner and at such time as the Secretary shall prescribe by regulations.

"(c) Definitions.—For purposes of this section—

"(1) Adoption expenses.—The term 'adoption expenses' means reasonable and necessary adoption fees, court costs, attorney fees, and other expenses which are directly related to the legal adoption of a child by the taxpayer and which are not incurred in violation of State or Federal law.

"(2) International adoption.—The term 'international adoption' means an adoption—

"(A) occurring under the laws of a foreign country, or

"(B) involving a child who was a citizen of a foreign country who—

"(i) was brought to the United States for the purpose of adoption, or

"(ii) came to the United States under circumstances with respect to which the necessity for the child's placement in adoption proceedings was reasonably foreseeable.".

(2) CONFORMING AMENDMENTS.—

(A) Section 62 of such Code (defining adjusted gross income) is amended by inserting after paragraph (16) the following new paragraph:

"(17) ADOPTION EXPENSES.—The deduction allowed by section 221.".

(B) The table of sections for such part VII is amended by striking out the item relating to section 221 and inserting in lieu thereof the following:

"Sec. 221. Adoption expenses.
"Sec. 222. Cross references.".

(b) CREDIT.—

(1) IN GENERAL.—Subpart A of part IV of subchapter A of chapter 1 of the Internal Revenue Code of 1954 (relating to credits against tax) is amended by inserting before section 45 the following new section:

"SEC. 44F. ADOPTION EXPENSES.

"(a) IN GENERAL.—In the case of an individual, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the adoption expenses paid or incurred by the taxpayer during the taxable year.

"(b) LIMITATIONS.—

"(1) MINIMUM DOLLAR AMOUNT.—The first $500 of adoption expenses paid or incurred with respect to the adoption of any child shall not be taken into account under subsection (a).

"(2) MAXIMUM DOLLAR AMOUNT.—The aggregate amount allowable as a credit under subsection (a) for all taxable years with respect to the adoption of any child shall not exceed $3,500 ($4,500 in the case of an international adoption).

"(c) APPLICATION WITH OTHER CREDITS.—The credit allowed by subsection (a) shall not exceed the tax imposed by this chapter for the taxable year, reduced by the sum of the credits allowable under a section of this subpart having a lower number or letter designation than this section, other than the credits allowable by sections 31, 39, and 43.

"(d) DEFINITIONS.—For purposes of this section, the terms 'adoption expenses' and 'international adoption' have the meaning given such terms under section 221(c).".

(2) CONFORMING AMENDMENTS.—

(A) The table of sections for subpart A of part IV of subchapter A of chapter 1 of such

Code is amended by inserting at the end thereof the following new item:

"44F. Adoption expenses.".

(B) Section 6096(b) of such Code (relating to designation of income tax payment to Presidential Election Campaign Fund) is amended by striking out "and 44E" and inserting in lieu thereof "section 44E, and section 44F".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to expenses paid or incurred in connection with any adoption which becomes final after December 31, 1980.

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II

97TH CONGRESS
1ST SESSION

S. 1656

To amend the Internal Revenue Code of 1954 to clarify certain requirements which apply to mortgage subsidy bonds, and for other purposes.

IN THE SENATE OF THE UNITED STATES

SEPTEMBER 23 (legislative day, SEPTEMBER 9), 1981

Mr. DURENBERGER (for himself, Mr. ROTH, Mr. CHAFEE, Mr. BRADLEY, and Mr. HEINZ) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to clarify certain requirements which apply to mortgage subsidy bonds, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. MORTGAGE SUBSIDY BONDS.

(a) GOOD FAITH COMPLIANCE.—Subparagraph (B) of section 103A(c)(2) of the Internal Revenue Code of 1954 (relating to good faith effort to comply with mortgage eligibility requirements) is amended to read as follows:

"(B) GOOD FAITH EFFORT TO COMPLY WITH MORTGAGE ELIGIBILITY REQUIREMENTS.—

"(i) IN GENERAL.—An issue which fails to meet one or more of the requirements of subsections (d), (e), and (f) and paragraphs (2) and (3) of subsection (j) shall be treated as meeting such requirements if—

"(I) the issuer in good faith attempted to meet all such requirements before the mortgages were executed,

"(II) 95 percent or more of the proceeds devoted to owner financing was devoted to residences with respect to which (at the time the mortgages were executed) all such requirements were met,

"(III) the issuer undertakes periodic, cost-effective audits and prosecutes any person who has committed fraud with respect to such requirements, and

"(IV) any failure to meet such requirements is corrected within a reasonable period after such failure is first discovered.

"(ii) CORRECTION OF FAILURE.—For purposes of clause (i)(II), any requirement which is not met at the time the mortgage is executed shall be treated as having been met at such time if—

"(I) the failure to meet such requirement has been corrected, or

"(II) diligent efforts are being made to correct the failure to meet such requirement.".

(b) INCREASE IN AMOUNT OF MORTGAGE INTEREST LIMITATION.—

(1) IN GENERAL.—Paragraph (2) of section 103A(i) of such Code (relating to effective rate of mortgage interest) is amended by striking out "1 percentage point" and inserting in lieu thereof "1¼ percentage points".

(2) CONFORMING AMENDMENTS.—

(A) Subparagraph (C) of section 103A(i)(4) of such Code (relating to arbitrage and investment gains) is amended—

(i) by striking out "1 percentage point" in clause (ii), and

(ii) by striking out the caption and inserting in lieu thereof the following:

"(C) REDUCTION BY UNUSED PARAGRAPH (2) AMOUNT.—".

(B) Paragraph (2) of section 103A(i) of such Code is amended by striking out the caption and inserting in lieu thereof the following:

"(2) LIMITATION ON EFFECTIVE RATE OF MORTGAGE INTEREST.—".

(c) DISPOSITION OF NONMORTGAGE INVESTMENT IN CASE OF LOSS.—Paragraph (3) of section 103A(i) of such Code (relating to nonmortgage investment requirements) is amended by adding at the end thereof the following new subparagraph:

"(D) NO DISPOSITION IN CASE OF LOSS.—This paragraph shall not require the sale or disposition of any investment if such sale or disposition would result in a loss which exceeds the amount which would be paid or credited to the mortgagors under paragraph (4)(A) (but for such sale or disposition) at the time of such sale or disposition.".

(d) ELIMINATION OF REGISTRATION REQUIREMENTS.—

(1) IN GENERAL.—Subsection (j) of section 103A of such Code (relating to other requirements) is amended by striking out paragraph (1) and redesignating

paragraphs (2) and (3) as paragraphs (1) and (2), respectively.

(2) CONFORMING AMENDMENTS.—Subsection (c) of section 103A of such Code (relating to qualified mortgage issue), as amended by subsection (a) of this Act, is amended—

(A) by striking out "and (f) and paragraphs (2) and (3) of subsection" in paragraph (2)(B)(i) and inserting in lieu thereof "(f), and",

(B) by striking out ", and paragraph (1) of subsection (j)" in paragraph (2)(C), and

(C) by striking out "subsection (j)(2)" in paragraph (3)(C) and inserting in lieu thereof "subsection (j)(1)".

SEC. 2. INDUSTRIAL DEVELOPMENT BONDS FOR CERTAIN RESIDENTIAL RENTAL PROPERTY.

(a) IN GENERAL.—Subparagraph (A) of section 103(b)(4) of the Internal Revenue Code of 1954 (relating to certain exempt activities) is amended to read as follows:

"(A) projects for residential rental property if at all times during the qualified project period—

"(i) 15 percent or more in the case of targeted area projects, or

"(ii) 20 percent or more in the case of any other project, of the units in each project are to be occupied by individuals of low or moderate income,".

(b) Definitions.—Subsection (b) of section 103 of such Code (relating to industrial development bonds) is amended by adding at the end thereof the following new paragraph:

"(11) Projects for residential rental property.—For purposes of paragraph (4)(A)—

"(A) Targeted area project.—The term 'targeted area project' means—

"(i) a project located in a qualified census tract (within the meaning of section 103A(k)(2), or

"(ii) an area of chronic economic distress (within the meaning of section 103A(k)(3).

"(B) Qualified project period.—The term 'qualified project period' means the period beginning on the first day on which a unit of the project is occupied and ending on the later of—

"(i) the date which is 10 years after the date on which such period begins,

"(ii) the date which is a qualified number of days after the date on which such period begins, or "(iii) the date on which any assistance provided with respect to the project under section 8 of the United States Housing Act of 1937 terminates.

For purposes of clause (ii), the term 'qualified number' means, with respect to an obligation described in paragraph (4)(A), 50 percent of the number of days which comprise the term of such obligation.

"(C) INDIVIDUAL OF LOW OR MODERATE INCOME.—

"(i) IN GENERAL.—The term 'individual of low or moderate income' means an individual who—

"(I) has a gross income for the taxable year in which such individual begins residing in a unit of the project which does not exceed 80 percent of the median gross income for the calendar year ending with, or within, such taxable year of all individuals residing within the area in which such unit is located, or

"(II) is classified as an individual of low or moderate income under regulations prescribed by the Secretary of Housing and Urban Development.

"(ii) MEDIAN GROSS INCOME.—For purposes of clause (i)(I), the median gross income of all individuals residing within a certain area shall be determined on the basis of estimates which the Secretary of Housing and Urban Development shall make for each calendar year and shall publish in the Federal Register.

"(iii) REGULATIONS.—In prescribing regulations under clause (i)(II), the Secretary of Housing and Urban Development may take into consideration the size of the individual's household and may prescribe a gross income limitation which differs from the limitation in clause (i)(I) if the Secretary finds such variance is justified due to construction costs, unusually high or low gross income levels, or other factors prevailing in the area.".

(c) CONFORMING AMENDMENT.—Paragraph (4) of section 103(b) of such Code is amended by striking out the second sentence thereof.

SEC. 3. EFFECTIVE DATE.

The amendments made by this Act shall apply to obligations issued after the date of enactment of this Act.

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DESCRIPTION OF TAX BILLS

(S. 425, S. 608, S. 1348, S. 1479, S. 1580, and S. 1656)

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on October 16, 1981, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are six bills scheduled for the hearing: S. 425, S. 1348, and S. 1656 (relating to mortgage revenue bonds) and S. 608, S. 1479, and S. 1580 (generally relating to adoption expenses).

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, issues, explanation, effective dates, and revenue effects.

I. SUMMARY

1. S. 425—Senators Packwood and Hatfield

Additional Transitional Rule to Mortgage Subsidy Bond Tax Act

The bill would provide an additional transitional rule to the Mortgage Subsidy Bond Tax Act of 1980, for $500 million of general obligation bonds of the State of Oregon for financing housing for veterans.

2. S. 608—Senator Baucus

Expanded Deduction for Certain Adoption Expenses

Present law provides an itemized deduction for up to $1,500 of expenses paid by an individual in adopting a "child with special needs" (sec. 222). The deduction applies where the child, because of a specific factor such as age, ethnic background, medical condition, or handicap, cannot reasonably be expected to be adopted unless adoption assistance is provided. This provision, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34), applies in 1981 and subsequent years.

The bill would expand the adoption expense deduction by extending it to all individual taxpayers, whether or not they itemize deductions; by allowing the deduction for expenses of adopting any child, whether or not the child is considered to have "special needs"; and by allowing an unlimited amount of deductible adoption expenses. In general, this "above-the-line" deduction would be available for reasonable and necessary expenses of a legal adoption arranged by a public welfare department or a nonprofit voluntary adoption agency.

The provisions of the bill would apply to taxable years beginning after 1981.

3. S. 1348—Senators Sasser, Baker, Bumpers, Pryor, Packwood, Pell, Danforth, Chafee, Durenberger, Baucus, Bradley, Mitchell, and others

Amendments to the Mortgage Subsidy Bond Tax Act

The bill would make a number of amendments to the Mortgage Subsidy Bond Tax Act of 1980.

First, the bill would provide that certain targeting provisions of the Act would be considered satisfied if the issuer attempts to enforce compliance with those provisions in good faith and corrects any failures within a reasonable time after discovery of the failure. In addition, bondholders would be able to rely upon a covenant by the issuer that the issuer attempted to comply with the targeting provisions in good faith.

Second, the bill would modify the rule of present law that prohibits an individual from being eligible to receive a mortgage financed by a mortgage subsidy bond if he owned a residence within three years, by providing that the requirement is met if the mortgagor certifies that he has met the three-year rule. In addition, the bill would provide exceptions to the three-year rule in the case of individuals who lived in residences that were either (1) made uninhabitable by disaster or governmental action or (2) certified by an appropriate State or local official as not meeting certain minimum housing standards.

Under present law, the three-year rule does not apply to targeted area residences. The bill would enlarge the definition of targeted area residences to include residences in energy-impacted areas. In addition, the bill would modify the present definition of areas of chronic economic distress, to provide that a State has complete discretion in determining the areas covered by such definition so long as such areas do not cover more than 25 percent of the geographical area of the State.

Third, the bill would modify the purchase price limitation by (1) clarifying that the average purchase price need not be determined more than twice during any 12-month period, and (2) permitting the exclusion from the computation of the average purchase price of those residences which are not typically financed through a normal real estate mortgage loan (e.g., mobile homes). In addition, the bill would permit the computation of the average area purchase price by combining two or more statistical areas.

Fourth, the bill would modify the arbitrage limitations of the Mortgage Subsidy Bond Tax Act of 1980 in several respects. First, it would increase the allowable arbitrage on mortgage investments from one percentage point to one and a half percentage points. Second, it would modify the computation of yield on the bonds to permit relending of bond proceeds for new additional loans. Third, it would permit unlimited arbitrage on nonmortgage investments for a temporary period until the excess funds are reloaned in new mortgages. Fourth, it would provide an exception to the restrictions on arbitrage on nonmortgage investments so that no investment would have to be sold at a loss. Fifth, with respect to arbitrage that must be paid to mortgagors or the Federal Government, the bill would permit the withholding of amounts for a reasonable reserve against losses on investments, would permit the issuer to determine when such payments would be made, and would permit the issuer to modify at any time its rules as to which mortgagors would receive the payments. Finally, the bill would modify the arbitrage rules to permit their application to two or more issues on a combined basis.

Fifth, the bill would provide an exception to the rule of present law that the targeting provisions must also be met in the case of mortgage assumptions in the case of mortgages which are FHA-insured or VA-guaranteed.

Sixth, the bill would repeal the registration requirements as they apply to mortgage subsidy bonds and to industrial development bonds that are used to provide rental housing.

The provisions of the bill would be effective as if they had been included in the Mortgage Subsidy Bond Tax Act of 1980.

4. S. 1479—Senators Metzenbaum, Tsongas, and Williams

Tax Benefits for Employer Adoption Expense Plans; Expanded Deduction for Certain Adoption Expenses

Present law provides an itemized deduction for up to $1,500 of expenses paid by an individual in adopting a "child with special needs" (sec. 222). The deduction applies where the child, because of a specific factor such as age, ethnic background, medical condition, or handicap, cannot reasonably be expected to be adopted unless adoption assistance is provided. This provision, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34), applies in 1981 and subsequent years.

The bill would exclude from the gross income of an employee amounts received for adoption expenses under a qualified (nondiscriminatory) plan established by the employer. The employer would be permitted to deduct amounts contributed to the adoption expense plan. In general, this rule would apply with respect to reasonable and necessary expenses of a legal adoption arranged by a public welfare department or nonprofit voluntary adoption agency.

In addition, individuals would be permitted under the bill to deduct adoption expenses (other than those provided through an employer plan), whether or not they itemize deductions. The bill would also expand the existing adoption expense deduction by allowing an unlimited amount of deductible adoption expenses and by allowing the deduction for the expenses of legally adopting any child, whether or not the child is considered to have "special needs."

The provisions of the bill would apply to taxable years beginning after 1980.

5. S. 1580—Senator Jepsen

Additional Exemption for Childbirth or Adoption; Deduction or Credit for Certain Adoption Expenses

Present law provides an itemized deduction for up to $1,500 of expenses paid by an individual in adopting a "child with special needs" (sec. 222). The deduction applies where the child, because of a specific factor such as age, ethnic background, medical condition, or handicap, cannot reasonably be expected to be adopted unless adoption assistance is provided. This provision, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34), applies in 1981 and subsequent years.

The bill would provide married taxpayers who give birth to or adopt a child with an additional personal exemption of $1,000 for the year in which the child is born or adopted. If the child is handicapped, the additional personal exemption would be increased to $3,000. In addition, married taxpayers who adopt a child who either (1) is age six or over or (2) is a member of a minority race or ethnic group would be entitled to an additional personal exemption of $3,000.

The bill also would give individuals an election to deduct or take a tax credit for certain expenses of legally adopting a child, whether or not the child is considered to have "special needs." The deduction or credit would be limited to the first $3,500 ($4,500 in the case of an international adoption) of adoption expenses in excess of $500. The deduction would be available whether or not the taxpayer itemizes.

The provisions of the bill generally would apply with respect to births or adoptions after 1980.

6. S. 1656—Senators Durenberger, Roth, Chafee, Bradley, Heinz, Melcher, Symms, and Stennis

Amendments to the Mortgage Subsidy Bond Tax Act

The bill would amend the Mortgage Subsidy Bond Tax Act of 1980 with respect to both mortgage subsidy bonds for single-family residences and industrial development bonds for multi-family rental housing.

Mortgage subsidy bonds for single-family residences

The bill would provide that certain of the targeting provisions of the Act would be considered satisfied if (1) the issuer attempts to comply with those targeting provisions in good faith, (2) the targeting requirements are met with respect to 95 percent of the financing at the time the bonds are issued, (3) the issuer undertakes periodic, cost-effective audits and prosecutes any person who has committed fraud with respect to such requirements, and (4) any failure to meet the requirements is corrected within a reasonable period of its detection.

The bill would modify the arbitrage limitations of the Act by increasing the allowable arbitrage on mortgage investments from one percentage point to one and a quarter percentage points. Also, the bill would provide that the rule limiting arbitrage on nonmortgage investments that exceed 150 percent of debt service does not apply if it would require disposition of any investment at a loss.

The bill would repeal the registration requirements as they apply to mortgage subsidy bonds.

Industrial development bonds for multi-family rental housing

The bill would provide that the targeted group of tenants who would qualify a project for tax-exempt industrial development bonds would be either (1) those individuals whose incomes do not exceed 80 percent of the area median gross income or (2) those individuals who are classified as individuals of low or moderate income by the Secretary of Housing and Urban Development. Under present law, the targeted group conforms to those individuals who are eligible to receive Section 8 rental housing assistance.

Under present law, the targeted requirement must be met for at least 20 years in order for industrial development bonds for multi-family rental projects to be tax-exempt. The bill would provide that the targeting requirement need not be met until after the later of (1) ten years from the date of first occupancy, (2) a date ending when 50 percent of the maturity of the bond has gone by, or (3) the date on which any Section 8 assistance for the project terminates.

The bill would also repeal the registration requirement as it applies to industrial development bonds for multi-family rental housing.

The provisions of the bill would apply with respect to obligations issued after the date of enactment.

II. DESCRIPTION OF BILLS

1. S. 425—Senators Packwood and Hatfield

Additional Transitional Rule to Mortgage Subsidy Bond Tax Act

Present law

The Mortgage Subsidy Bond Tax Act of 1980 was enacted as part of the Omnibus Reconciliation Act of 1980 (P.L. 96–499). The Act was intended generally to direct the subsidy from use of tax-exempt bonds for housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to restrict the overall revenue loss from the use of tax-exempt bonds for housing. The Act had numerous transitional rules.

Issue

The issue is whether an additional transitional rule should be added to the Mortgage Subsidy Bond Tax Act of 1980 to exempt from the restrictions of that Act $500 million of general obligation bonds issued by the State of Oregon for financing housing for veterans.

Explanation of the bill

The bill would add an additional transitional rule to the Mortgage Subsidy Bond Tax Act of 1980. That rule would exempt from the requirements of that Act $500 million of general obligation bonds issued by the State of Oregon between January 7, 1981, and April, 1981, for mortgage financing for veterans qualified under the Oregon Department of Veterans' Affairs program.

Effective date

The provisions of the bill would be effective as if they had been included in the Mortgage Subsidy Bond Tax Act of 1980.

Revenue effect

The bill is estimated to reduce fiscal year budget receipts by $1 million in 1982 and $3 million annually for 1983 through 1986.

2. S. 608—Senator Baucus

Expanded Deduction for Certain Adoption Expenses

Present law

Present law provides an itemized deduction for qualified expenses paid or incurred by an individual in adopting a "child with special needs" (Code sec. 222). The aggregate amount of such expenses which may be deducted with respect to the adoption of any one child may not exceed $1,500. This provision, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34), applies to taxable years beginning after December 31, 1980.

For purposes of this new deduction, qualified adoption expenses are defined as reasonable and necessary adoption fees, court costs, attorney fees, and other expenses which are directly related to a legal adoption. The term "child with special needs" means a child as to whom adoption assistance payments are made under section 473 of the Social Security Act.[1] In general, this is a child (1) who the State has determined cannot or should not be returned to the home of the natural parents, and (2) who, on account of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental, or emotional handicap), cannot reasonably be expected to be placed with adoptive parents unless adoption assistance is provided.

An expense which is allowable as a deduction or credit under any other Code section (for example, medical expenses above the three-percent floor) may not also be deducted as an adoption expense; that is, the same expense cannot give rise to a double tax benefit. No deduction is allowable for expenses that are paid from funds received under a Federal, State, or local program, or that are incurred in violation of Federal or State law.

Issues

The issues presented by the bill include the following:

(1) Whether the newly enacted itemized deduction for certain adoption expenses should also be made available to individuals who do not itemize deductions;

(2) Whether a deduction should be provided for the expenses of adopting any child, including a child who is not considered difficult to place; and

(3) Whether adoption expenses should be deductible without limitation on amount.

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[1] Adoption assistance under the Social Security Act provides an ongoing maintenance payment, but does not reimburse adoption expenses.

Explanation of the bill

The bill would provide an "above-the-line" deduction to individuals for adoption expenses paid or incurred during the taxable year. This deduction would be taken from gross income; thus, it would be available whether or not the individual itemizes other personal deductions. There would be no dollar limit on the amount of adoption expenses which could be deducted.

Under the bill, deductible adoption expenses would be reasonable and necessary adoption agency fees, court costs, attorney fees, and other expenses that are directly related to the legal adoption of a child by the taxpayer. In order for adoption expenses to be deductible under the bill, the adoption to which the expenses relate must be arranged by a public welfare department (or similar State or local public social service agency with legal responsibility for child placement) or by a not-for-profit voluntary adoption agency that is authorized by a State or local government to place children for adoption.

An amount which is taken into account in computing a deduction or credit under any other Code section could not also be deducted as an adoption expense; that is, the same expense could not give rise to a double tax benefit. No deduction would be allowable for expenses that are incurred in violation of Federal or State law.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1981.

Revenue effect

The bill is estimated to reduce fiscal year budget receipts by $5 million in 1982, $32 million in 1983, $32 million in 1984, $32 million in 1985, and $34 million in 1986.

3. S. 1348—Senators Sasser, Baker, Bumpers, Pryor, Packwood, Pell, Danforth, Chafee, Durenberger, Baucus, Bradley, Mitchell, and others

Amendments to the Mortgage Subsidy Bond Tax Act

Present law

In general

The Mortgage Subsidy Bond Tax Act of 1980 was enacted as part of the Omnibus Reconciliation Act of 1980 (P.L. 96–499). The Act was intended generally to direct the subsidy from the use of tax-exempt bonds for housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to restrict the overall revenue loss from the use of tax-exempt bonds for housing.

Targeting mechanism

The Act contains a number of requirements to achieve the goals set forth above. Under the Act, the requirements are divided into two groups.

As to one group of requirements, the issue meets the requirements only if the issuer in good faith attempted to satisfy such requirements before the mortgages were executed. Where such good faith has been exercised, 95 percent or more of the proceeds that are devoted to financing of owner-occupied residences (referred to as lendable proceeds) must have been invested in mortgages which meet all requirements in the group at the time of the execution of the mortgages. In addition, where the good faith and 95 percent requirements are met, failures to meet the first group of requirements in any mortgage must be corrected within a reasonable period after such failure is first discovered.

The requirements that come within this group of requirements are the residence requirement, the three-year requirement, the purchase price requirement, the new mortgage requirement, and the assumption requirement.

With respect to the other group of requirements, the issue meets the requirements only if the issuer in good faith attempted to satisfy all of such requirements and any failure to meet such requirements is due to inadvertent error. The requirements included in this group are the market share limitation, the portion of loans in targeted areas requirement, the arbitrage requirement, and the registration requirement.

Three-year requirement

In order for an issue to be a qualified mortgage issue, all of the mortgages financed from the bond proceeds must be provided to mortgagors each of whom did not have a present ownership interest in a principal residence at any time during the three-year period ending on the date that the mortgage is executed.

The three-year requirement does not apply with respect to mortgagors of residences in three situations. First, it does not apply to mortgagors of residences that are located in a targeted area. Second, it does not apply to mortgagors who receive qualified home improvement loans. Third, it does not apply to mortgagors who receive a qualified rehabilitation loan.

A targeted area residence is defined to mean a residence located in either one of two areas: (1) a qualified census tract or (2) an area of chronic economic distress.

A qualified census tract is a census tract in which 70 percent or more of the families have income which is 80 percent or less of the Statewide median family income. This determination is to be based on the most recent decennial census for which data are available.

An area of chronic economic distress is defined as an area which has been designated as such by the State in accordance with its standards and which designated area has been approved by the Departments of Treasury and Housing and Urban Development as an area of chronic economic distress. The criteria to be used by the Departments in approving an area as an area of chronic economic distress are: (1) the condition of the housing stock, including the age of the housing and the number of abandoned and substandard residential units; (2) the need of area residents for owner-financing through tax-exempt bonds, as indicated by low per capita income, a high percentage of families in poverty, a high number of welfare recipients, and high unemployment rates; (3) the potential for use of owner-financing through tax-exempt bonds to improve housing conditions in the area; and (4) the existence of a housing assistance plan which provides a displacement program and a public improvements and services program.

Purchase price requirement

In order for an issue to be a qualified mortgage issue, all of the mortgages (or other financing) provided from the bond proceeds, except qualified home improvement loans, must be for the purchase of residences where the acquisition cost of each residence does not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to that resident.

The average area purchase price means the average purchase price of all single-family residences in the statistical area in which the residence is located. The average is to be based on sales during the most recent 12-month period for which sufficient statistical information is available.[1] Whether a particular residence meets the purchase price requirement is to be determined on the date that the mortgage originator makes a commitment to provide financing from the bond proceeds (or, if earlier, the date of the purchase of the residence). Separate determinations are to be made for new and used residences.

The term "statistical area" is defined to mean a standard metropolitan statistical area (SMSA) or any county, or portion of a county, which is not within an SMSA. Where an SMSA covers a portion of a county, the portion of the county that is not covered by the SMSA is treated as a separate statistical area. An SMSA is defined to mean those areas so designated by the Secretary of Commerce. If a portion of a State is in neither an SMSA nor a county (as occurs in the State of Alaska), the statistical area is to be the area designated by the Treasury Department as the equivalent of a county.

Arbitrage

In general

In order for an issue to be a qualified mortgage issue, the issue must meet certain requirements regarding arbitrage as to both mortgage loans and nonmortgage investments.

Under the Act, the effective rate of interest on mortgages provided under the issue cannot exceed the yield on the issue by more than one percentage point. This determination is to be made on a composite basis for all mortgages under the issue. Consequently, the effective interest rate on some mortgages may be greater than one percentage point above the yield of the issue if other mortgages have a lower effective interest rate.

In general, this requirement imposes a limitation on the amount of costs a mortgagor is required to pay, such as underwriter commissions and other issuance costs, servicing fees, and trustee fees. Under this provision, the total cost of issuing the bonds and providing mortgage financing which may be passed on to the mortgagors may not exceed the yield on the issue by more than one percentage point.

Determination of interest rate, yield

The Act provides three rules for determining the effective rate of interest on any mortgage. The first rule deals with the amount to be taken into account in determining the effective rate of interest on any mortgage. The second rule deals with prepayment assumptions. The third rule deals with actuarial assumptions.

The first rule provides that the effective rate of interest on any mortgage is determined by taking into account all amounts borne by the mortgagor which are attributable to the mortgage or to the bond issue.

The second rule provides that in determining the effective rate of interest on any mortgage, it shall be assumed that the mortgage prepayment rate will be the rate set forth in the most recent mortgage maturity experience table published by the Federal Housing Administration for the State (or, if available, the area within the State) in which the residences are located. This rule addresses the problem of determining the effective rate of interest on a mortgage where prepayment occurs. Generally, where a point or fee is charged upon origination or prepayment of a mortgage, the effective rate of interest on the mortgage will vary depending on whether some or all of the mortgages are prepaid. In addition, the exact pattern of prepayments of the mortgages is not known at the time the bonds are issued. The Act addresses the problem by providing that the FHA maturity experience tables shall be used to determine the mortgage prepayment rate in determining the effective interest rate. Thus, the mortgages are to be treated as prepaying on the basis of 100 percent of FHA tables.

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[1] Temporary regulations issued by the Treasury Department provide a safe harbor rule under which an issuer may rely on the average purchase price published by the Treasury for an area for the period stated at the time of publication (Temp. Reg. § 6a.103A-2(f)(5)).

The third rule provides that the effective rate of interest on the mortgages is to be determined on an actuarial basis. All amounts that are taken into account in determining the effective rate of interest are discounted, from the time the amount is received, to an amount equal to the "purchase price" of the mortgage. The discount rate which will discount all present and future receipts to the purchase price is the effective rate of interest on the mortgages.

The Act also provides certain rules for determining the yield on the issue. The yield on the bond issue is also to be computed on an actuarial basis.

Restrictions under the Act

The Act also imposes restrictions on the arbitrage on nonmortgage investments. Mortgage subsidy bonds usually have established a reserve of one and one-half times the maximum annual scheduled debt service. The Act provides that the reserve must be reduced as future annual debt service is reduced.

The Act also limits the amount that may be invested at unrestricted yield in nonmortgage investments to 150 percent of the debt service on the issue for the bond year. An exception to the 150-percent debt service rule is provided, however, for proceeds invested for an initial temporary period until such proceeds are needed for mortgages.

Present law also requires that arbitrage earned by the issuer on nonmortgage investments is to be paid or credited to the mortgagors or paid to the Federal Government. While the arbitrage rules do not explicitly so indicate, they appear to contemplate that the arbitrage rules are to be applied on an issue-by-issue basis.

Assumptions

In order for an issue to be a qualified mortgage issue, certain of the requirements for a qualified mortgage bond must be met by every mortgagor who assumes a mortgage that had been made from proceeds of a qualified mortgage issue. Those requirements are the residence requirement, the three-year requirement, and the purchase price requirement. These requirements are to be determined based upon the facts as they exist at the time of the assumption as if the loan were first being made at that time.

Registration

In order for an issue to be a qualified mortgage issue, all of the obligations which are part of the issue must be in registered form. Similarly, the Act requires that tax-exempt industrial development bonds for multi-family rental housing be in registered form.

Issues

The issues presented by the bill include the following:

(1) What standard of care should be imposed upon the issuer to insure that the targeting provisions of the Mortgage Subsidy Bond Tax Act of 1980 are enforced? What should be the enforcement mechanism if the funds are not properly targeted?

(2) What actions should the issuer be required to take to insure compliance with the three-year rule? Should additional exceptions to the three-year rule be provided for individuals owning housing made uninhabitable by a disaster or government action or living in sub-

standard housing? If so, what are the proper standards for determining substandard housing?

(3) Should the definition of targeted area residences be broadened to include "energy-impacted" areas? If so, how are such areas different from other areas where adequate housing is in short supply?

(4) Who should be designated to determine what areas are to be included within the areas of chronic economic distress, and what standards and limitations are appropriate in making such determinations?

(5) How often should the data on average area purchase price be determined? Should mobile homes be included in determining these averages?

(6) What is the appropriate level of arbitrage on mortgage investments? Should such a level be adequate to permit mortgage subsidy bonds to be issued without any contribution by State or local governments?

(7) Should the arbitrage rules be modified to permit the reinvestment in new mortgages of principal payments and prepayments of mortgages already financed with the bonds?

(8) Should an exception be provided to the restrictions on the size of nonmortgage investments where the sale of a nonmortgage investment would result in a loss?

(9) In determining the amount of arbitrage on nonmortgage investments that must be paid to the mortgagor or the Federal Government, should a reserve for loss on investments be permitted and should the issuer have complete discretion as to when such payments are to be made and to which of the mortgagors such payments should be made?

(10) Should an exception to the targeting rules be provided in the case of assumptions of FHA-insured and VA-guaranteed loans?

(11) Should the registration requirements be repealed?

Explanation of the bill

In general

The bill would modify a number of the rules and requirements of the Mortgage Subsidy Bond Tax Act of 1980.

Targeting mechanism

The bill would provide that the residence requirement, the three-year requirement, the purchase price requirement, the new mortgage requirement, and the assumption requirement would be met where (1) the issuer in good faith attempted to meet all such requirements before the mortgages were executed, and (2) any failure to meet those requirements is corrected within a reasonable period after such failure is first discovered.

In addition, the bill would provide that the tax-exempt status of interest on a mortgage subsidy bond would not be lost if issuer covenants that the issuer attempted and will attempt to comply with all of the targeting provisions of the Act unless the Treasury Department has published a notice of the issuer's failure to comply with the requirements prior to the sale of the issue.

Three-year requirement

The bill would modify the three-year rule to require only that the mortgagor certify that he did not have a present ownership interest in a principal residence within the three-year period prior to the execution of the mortgage. In addition, the bill would provide exceptions to the three-year rule (1) where the mortgagor had an interest in a residence which an appropriate State or local official has certified does not meet the minimum housing standards established for the area by the State or local government with respect to sanitation, heating, major structural deficiencies, or overcrowding, and (2) where the mortgagor had an ownership interest in a prior residence which can no longer be occupied on a permanent basis due to natural disaster or governmental action.

The bill would also modify the definition of targeted area residences in two respects. First, the bill would add a new additional area to targeted area residences for residences located in energy-impacted areas. An energy-impacted area would be defined as an area designated as impacted by increased production of coal, uranium, oil, gas, or other energy-related materials which meet the criteria set forth in section 601(a) of the Powerplant and Industrial Fuel Use Act of 1978 with respect to areas impacted by increased coal or uranium production. Second, the bill would modify the definition of "area of chronic economic distress" to mean an area of chronic economic distress designated by the State as meeting the standards established by the State, provided that areas of chronic economic distress may not exceed 25 percent of the geographic area within the State.[1]

Purchase price requirement

The bill would make two modifications to the rules applicable to the purchase price limitation. First, the bill would provide that the average purchase price for an area would not have to be recomputed more than twice during any 12-month period. Second, in determining the average area purchase price, the bill would permit the exclusion of residences which are not typically financed through a normal real estate mortgage loan (such as a residence to be located on land occupied under a lease having a term less than 15 years or a residence which is normally financed as personal property). In addition, the bill would modify the rules for determining the area used for measuring the average purchase price (e.g., the definition of "statistical area") to permit the combination of two or more statistical areas.

Arbitrage

The bill would make a number of modifications to the arbitrage requirements both as to mortgage investments and as to nonmortgage investments.

With respect to mortgage investments, the bill would increase the permissible level of arbitrage from 1.0 percentage points to 1.5 percentage points. The bill would also add a rule to clarify that the yield on the bonds would be computed based upon the assumption that funds could be used both to provide additional mortgages and to redeem bonds.

With respect to nonmortgage investments, the bill would modify the restriction on arbitrage on investments that exceed 150 percent of debt service to allow unlimited arbitrage during any temporary period (as opposed to the initial temporary period provided under present law) that funds are held for investment in mortgages. This change apparently is intended to aid in the relending of funds within an issue. In addition, the bill would add a rule that the 150 percent of debt service rule would not apply if it would require disposition of any investment at a loss.

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[1] Because the rule is expressed in terms of geographical area, targeted areas could cover substantially more or less than 25 percent of the State's population.

The bill would also allow the creation of a reasonable reserve for losses on investments to be taken into account in determining the amount of arbitrage on nonmortgage investments that must be paid to the mortgagors or the Federal Government. With respect to amounts paid to mortgagors, the bill would allow the amounts to be paid at the time of receipt or at the time of distribution and would allow for the change of the formula under which such amounts are distributed to mortgagors.

Finally, the bill would provide a rule intended to permit the application of the arbitrage rules to two or more issues on a combined basis.

Assumptions

The bill would provide exceptions to the present law rule on assumptions in the case of mortgages which are insured by the Federal Housing Administration or guaranteed by the Veterans Administration.

Registration

The bill would repeal the registration requirement for both mortgage subsidy bonds for single-family housing and for industrial development bonds for multi-family rental housing.

Effective date

The amendments made by the bill would apply as if they had been included in the Mortgage Subsidy Bond Tax Act of 1980.

Revenue effect

The bill is estimated to reduce fiscal year budget receipts by $4 million in 1982, $12 million in 1983, $18 million in 1984, $19 million in 1985, and $18 million in 1986.

4. S. 1479—Senators Metzenbaum, Tsongas, and Williams

Tax Benefits for Employer Adoption Expense Plans; Expanded Deduction for Certain Adoption Expenses

Present law

Present law provides an itemized deduction for qualified expenses paid or incurred by an individual in adopting a "child with special needs" (Code sec. 222). The aggregate amount of such expenses which may be deducted with respect to the adoption of any one child may not exceed $1,500. This provision, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34), applies to taxable years beginning after December 31, 1980.

For purposes of this new deduction, qualified adoption expenses are defined as reasonable and necessary adoption fees, court costs, attorney fees, and other expenses which are directly related to a legal adoption. The term "child with special needs" means a child as to whom adoption assistance payments are made under section 473 of the Social Security Act.[1] In general, this is a child (1) who the State has determined cannot or should not be returned to the home of the natural parents, and (2) who, on account of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental, or emotional handicap), cannot reasonably be expected to be placed with adoptive parents unless adoption assistance is provided.

An amount which is taken into account in computing a deduction or credit under any other Code section may not also be deducted as an adoption expense; that is the same expense cannot give rise to a double tax benefit. No deduction is allowable for expenses that are paid from funds received under a Federal, State, or local program, or that are incurred in violation of Federal or State law.

Issues

The issues presented by the bill include the following:

(1) Whether an income tax exclusion should be allowed to employees for employer-provided adoption expenses, and whether employers should receive a deduction for contributions to adoption expense plans;

(2) Whether the newly enacted itemized deduction for certain adoption expenses should also be made available to individuals who do not itemize deductions;

(3) Whether a deduction should be provided for the expenses of adopting any child, including a child who is not considered difficult to place; and

(4) Whether adoption expenses should be deductible without limitation on amount.

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[1] Adoption assistance under the Social Security Act provides an ongoing maintenance payment, but does not reimburse adoption expenses.

Explanation of the bill

Exclusion for employer-provided adoption expenses

The bill would exclude from the gross income of an employee amounts received under an adoption expense plan and amounts contributed by the employer, on behalf of the employee, to the plan. Employer contributions to the plan would be deductible by the employer as trade or business expenses. An adoption expense plan would be a written plan of an employer to reimburse employees for adoption expenses.

Adoption expenses, for this purpose, would be reasonable and necessary expenses (not incurred in violation of State or Federal law) that are directly related to the legal adoption of a child. These expenses would include legal fees, medical expenses, adoption fees, temporary foster care expenses, transportation costs, and expenses related to the pregnancy of the child's natural mother. To qualify, the adoption must be arranged by a public welfare department (or similar State or local public social service agency with legal responsibility for child placement) or by a not-for-profit voluntary adoption agency authorized by the State or local government to place children for adoption.

Adoption expense plans would be subject to the existing requirements for medical expense reimbursement plans (sec. 105(h)). Thus, in order to qualify for favorable tax treatment under the bill, an adoption expense plan could not discriminate in favor of highly compensated individuals with respect to eligibility requirements or benefits.

Expanded deduction for adoption expenses

The bill would provide an "above-the-line" deduction to individuals for adoption expenses, not compensated by insurance or otherwise, paid or incurred during the taxable year. This deduction would be taken from gross income; thus, it would be available whether or not the individual itemizes other personal deductions. There would be no dollar limit on the amount of adoption expenses which could be deducted.

The adoption expenses which would qualify under the bill for the deduction would be the same expenses that would qualify for the income exclusion if provided under an employer adoption expense plan. Thus, qualifying expenses would be reasonable and necessary expenses that are directly related to the legal adoption of a child by the taxpayer, where the adoption is arranged by a public welfare department or nonprofit voluntary adoption agency.

An amount which is taken into account in computing a deduction or credit under any other Code section could not also be deducted as an adoption expense: that is, the same expense could not give rise to a double tax benefit. Also, adoption expenses provided under an employer plan and excluded under the bill from an employee's gross income would not be deductible by the employee.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1980.

Revenue effect

The bill is estimated to reduce fiscal year budget receipts by $38 million in 1982, $33 million in 1983, $35 million in 1984, $37 million in 1985, and $41 million in 1986.

5. S. 1580—Senator Jepsen

Additional Exemption for Childbirth or Adoption; Deduction or Credit for Certain Adoption Expenses

Present law

Adoption expenses

Present law provides an itemized deduction for qualified adoption expenses paid or incurred by an individual in adopting a "child with special needs" (Code sec. 222). The aggregate amount of such expenses which may be deducted with respect to the adoption of any one child may not exceed $1,500. This provision, enacted as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34), applies to taxable years beginning after December 31, 1980.

For purposes of this new deduction, qualified adoption expenses are defined as reasonable and necessary adoption fees, court costs, attorney fees, and other expenses which are directly related to a legal adoption. The term "child with special needs" means a child as to whom adoption assistance payments are made under section 473 of the Social Security Act.[1] In general, this is a child (1) who the State has determined cannot or should not be returned to the home of the natural parents, and (2) who, on account of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental, or emotional handicap), cannot reasonably be expected to be placed with adoptive parents unless adoption assistance is provided.

An expense which is allowable as a deduction or credit under any other Code section (for example, medical expenses above the three-percent floor) may not also be deducted as an adoption expense; that is, the same expense cannot give rise to a double tax benefit. No deduction is allowable for expenses that are paid from funds received under a Federal, State, or local program, or that are incurred in violation of Federal or State law.

Personal exemptions

Present law provides personal exemptions of $1,000 for a taxpayer and for any dependent of the taxpayer. For a husband and wife filing a joint return, two personal exemptions of $1,000 are allowed, plus an exemption of $1,000 for any dependent. An additional exemption of $1,000 is allowed for a taxpayer age 65 or over and for a blind taxpayer.

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[1] Adoption assistance under the Social Security Act provides an ongoing maintenance payment, but does not reimburse adoption expenses.

Issues

The issues presented by the bill include the following:

(1) Whether an additional personal exemption should be provided to married individuals who give birth to, or adopt, a child, and if so, whether the amount of the exemption should be increased if the child is handicapped or in certain other situations;

(2) Whether the newly enacted itemized deduction for certain adoption expenses should also be made available to individuals who do not itemize deductions;

(3) Whether a deduction should be provided for the expenses of adopting any child, including a child who is not considered difficult to place;

(4) Whether the amount of deductible adoption expenses should be increased; and

(5) Whether a tax credit for adoption expenses should be provided.

Explanation of the bill

Additional personal exemption

The bill would provide married individuals who give birth to or adopt a child an additional personal exemption of $1,000 for the year in which the child is born or adopted. If the child is handicapped, the additional personal exemption would be increased to $3,000. In addition, married individuals who adopt a child who either (1) has attained age six before the first day of the year in which adopted or (2) is a member of a minority race or ethnic group would be entitled to an additional personal exemption of $3,000. The additional exemption would be provided only for the year of birth or adoption, and would not be available in the next or later years with respect to the child.

For purposes of the additional $3,000 exemption, a handicapped child would be a child who has a physical or mental disability (including blindness or deafness) which constitutes or results in a functional limitation to employment, or who has any physical or mental impairment (including a sight or hearing impairment) which substantially limits one or more major life activities.

In order to claim the additional personal exemption, the husband and wife must file a joint return for the year of the birth or adoption. If the taxpayers cannot use the exemption fully in one taxable year, any unused amount may be carried over as an exemption amount to the following year. An unmarried individual who adopts a child would not be eligible for the additional exemption.

Deduction for adoption expenses

The bill also would provide an "above-the-line" deduction for adoption expenses, to the extent exceeding $500, paid or incurred by an individual (including an unmarried individual). This deduction would be taken from gross income; thus, it would be available whether or not the individual itemizes other personal deductions. Deductible adoption expenses would be reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that are directly related to the legal adoption of a child, provided that the expenses are not incurred in violation of State or Federal law.

The first $500 paid or incurred in adopting any one child would not be deductible. The aggregate amount allowable as a deduction, for all taxable years, with respect to adopting a child generally could not exceed $3,500.

In the case of an "international adoption," the deduction limit would be increased to $4,500. An international adoption would be either (1) an adoption under the laws of a foreign country or (2) an adoption of a child who was a citizen of a foreign country and who was brought to the United States for the purpose of adoption or under circumstances making the child's placement for adoption reasonably foreseeable.

An amount which is allowable as a deduction or credit under any other Code section (for example, medical expenses above the three-percent floor) could not also be deducted as an adoption expense; that is, the same expense could not give rise to a double tax benefit. No deduction would be allowable for adoption expenses paid from funds received under Federal, State, or local programs.

Credit for adoption expenses

Instead of deducting adoption expenses, individuals could elect to claim an income tax credit. Under the bill, the credit would be available for up to $3,500 ($4,500 in the case of an international adoption) of adoption expenses in excess of $500.

Effective date

The additional personal exemption would apply to births or adoptions in taxable years beginning after December 31, 1980. The deduction or credit for adoption expenses would be available for amounts paid or incurred in connection with any adoption that becomes final after December 31, 1980.

Revenue effect

The bill is estimated to reduce fiscal year budget receipts by $1,063 million in 1982, $927 million in 1983, $884 million in 1984, $893 million in 1985, and $908 million in 1986.

6. S. 1656—Senators Durenberger, Roth, Chafee, Bradley, Heinz, Melcher, Symms, and Stennis

Modifications to the Mortgage Subsidy Bond Tax Act

Present law

In general

The Mortgage Subsidy Bond Tax Act of 1980 was enacted as part of the Omnibus Reconciliation Act of 1980 (P.L. 96–499). The Act was intended generally to direct the subsidy from the use of tax-exempt bonds for housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to housing. The Act provided new restrictions on tax-exempt mortgage subsidy bonds for single-family residences and modified the rules applicable to tax-exempt industrial development bonds for rental housing.

Mortgage subsidy bonds for single-family residences

Targeting mechanism

The Act contains a number of requirements to achieve the goals set forth above in the case of tax-exempt mortgage subsidy bonds to finance single-family residences. Under the Act, the requirements are divided into two groups.

As to one group of requirements, the issue meets the requirements only if the issuer in good faith attempted to satisfy all such requirements before the mortgages were executed. Where such good faith has been exercised, 95 percent or more of the proceeds that are devoted to financing of owner-occupied residences (referred to as lendable proceeds) must have been invested in mortgages which meet all requirements in the group at the time of the execution of the mortgages. In addition, where the good faith and 95 percent requirements are met, failures to meet the first group of requirements in any mortgage must be corrected within a reasonable period after such failure is first discovered.

The requirements that come within this group of requirements are the residence requirement, the three-year requirement, the purchase price requirement, the new mortgage requirement, and the assumption requirement.

With respect to the other group of requirements, the issue meets the requirements only if the issuer in good faith attempted to satisfy all of such requirements and any failure to meet such requirements is due to inadvertent error. The requirements included in this group are the market share limitation, the portion of loans in targeted areas requirement, the arbitrage requirements, and the registration requirement.

Arbitrage

In order for an issue to be a qualified mortgage issue, the issue must meet certain requirements regarding arbitrage as to both mortgage loans and nonmortgage investments.

Under the Act, the effective rate of interest on mortgages provided under the issue cannot exceed the yield on the issue by more than one percentage point. This determination is to be made on a composite basis for all mortgages under the issue. Consequently, the effective interest rate on some mortgages may be greater than one percentage point above the yield of the issue if other mortgages have a lower effective interest rate.

In general, this requirement imposes a limitation on the amount of costs a mortgagor is required to pay such as underwriter commissions and other issuance costs, servicing fees, and trustee fees. Under this provision, the total cost of issuing the bonds and providing mortgage financing which may be passed on to the mortgagors may not exceed the yield on the issue by more than one percentage point.

The Act also imposes restrictions on the arbitrage on nonmortgage investments. Mortgage subsidy bonds usually have established a reserve of one and one-half times the maximum annual scheduled debt service. The Act provides that the reserve be reduced as future annual debt service is reduced. The Act also limits the amount that may be invested at unrestricted yield in nonmortgage investments to 150 percent of the debt service on the issue for the bond year.

Registration

In order for an issue to be a qualified mortgage issue, all of the obligations which are part of the issue must be in registered form.

Industrial development bonds for multi-family rental housing

Under the Act, interest on an industrial development bond substantially all the proceeds of which are used to provide a qualifying project for residential rental property is exempt from Federal income taxation. A project will be treated as meeting the requirements of the provision only if 20 percent (15 percent in targeted areas) or more of the units in the project are to be occupied by individuals of low or moderate income.

The term "low or moderate income" has the same meaning as in Code section 167(k)(3)(B). Under that section, low or moderate income is to be determined by the Treasury in a manner consistent with the Leased Housing Program under section 8 of the United States Housing Act of 1937. The current Treasury regulations provide that occupants of a dwelling unit generally are considered families and individuals of low or moderate income only if their adjusted income does not exceed 80 percent of the median income for the area, as determined by the Secretary of Housing and Urban Development.[1]

In order to qualify under this provision, 20 percent (15 percent in targeted areas) or more of the units in each project must be occupied by qualifying individuals on an ongoing basis. However, where an individual satisfies the low or moderate income test at the time first occupying a unit in a project, that occupant will be treated as a qualifying individual as long as he or she continues to reside in the project, even though the occupant later ceases to be an individual with low or moderate income. Moreover, where a qualifying individual leaves the project, the unoccupied unit will continue as a qualifying unit until it is reoccupied by another tenant, at which time the status of the new tenant as a qualifying individual is to be determined.

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[1] These regulations presumably are to be modified to take account of the changes made to the section 8 rules by the Omnibus Budget Reconciliation Act of 1981 (P.L. 97-35).

The 20 (or 15) percent test generally must be met during the entire time that the bonds are outstanding. However, the Act contains a special rule for bonds issued before January 1, 1984 (and which do not come within the transitional rules) under which the 20 (or 15) percent test need be met only for a period of 20 years. The 20-year period begins on the first date that the project is available for occupancy and that the tax-exempt obligations are outstanding. Under this special rule, the 20-percent test will be met where the developer of the project has entered into a contract with a Federal or State agency that requires that at least 20 (or 15) percent of the units be maintained for persons of low or moderate income for a period of at least 20 years and provides rent subsidies for such persons for that period.

Issues

The issues presented by the bill include the following.

Mortgage subsidy bonds for single-family residences

(1) What standard of care should be imposed upon the issuer to insure that the targeting provisions of the Mortgage Subsidy Bond Tax Act of 1980 are enforced? What should be the enforcement mechanism if the funds are not properly targeted?

(2) What is the appropriate level of arbitrage on mortgage investments? Should such a level be adequate to permit mortgage subsidy bonds to be issued without any contribution by State or local governments?

(3) Should an exception be provided to the restrictions on the size of nonmortgage investments where the sale of a nonmortgage investment would result in a loss?

(4) Should the registration requirement be repealed?

Industrial development bonds for multi-family rental housing

(1) Should the targeted group of tenants which will qualify an industrial development bond for tax-exempt status be permanently established as those individuals whose income is 80 percent of the median gross income for an area or be determined by the Secretary of Housing and Urban Development from time to time, or should the targeted group automatically be limited to those individuals who would be eligible to receive direct rental assistance (under section 8 of the United States Housing Act of 1937)?

(2) How long should the lessor be committed to provide rental housing to the targeted group of tenants in order to be eligible for tax-exempt industrial development bond financing?

(3) Should the registration requirement be repealed?

Explanation of the bill

Mortgage subsidy bonds for single-family residences

Targeting mechanism

The bill would provide that the residence requirement, the three-year requirement, the purchase price requirement, the new mortgage requirement, and the assumption requirement would be met if (1) the issuer in good faith attempted to meet all such requirements before the mortgages were executed, (2) 95 percent or more of the proceeds devoted to owner financing are devoted to residences with respect to which the requirements were met at the time the mortgages were executed, (3) the issuer undertakes periodic, cost-effective audits and prosecutes any person who has committed fraud with respect to such requirements, and (4) any failure to meet those requirements is corrected within a reasonable period after such failure is first discovered. For purposes of ascertaining whether the requirements are met at the time the mortgages were executed, a requirement may be treated as having been met if any failure to meet a requirement is corrected or if diligent efforts are being made to correct such failure.

Arbitrage

The bill would modify the arbitrage requirements both as to mortgage investments and as to nonmortgage investments.

With respect to mortgage investments, the bill would increase the permissible level of arbitrage from 1.0 percentage points to 1.25 percentage points.

With respect to nonmortgage investments, the bill would modify the restriction on arbitrage on investments that exceed 150 percent of debt service to provide that the 150 percent of debt service rule would not apply if it would require disposition of any investment at a loss.

Registration

The bill would repeal the registration requirement for mortgage subsidy bonds for single-family residences.

Industrial development bonds for multi-family rental housing

Targeted group

The bill would modify the provisions of present law to provide that individuals with "low or moderate" income, for whom 20 (or, in targeted areas, 15) percent of the bond-financed units must be targeted, are (1) those individuals whose incomes do not exceed 80 percent of the area median gross income or (2) those individuals who are classified as individuals of low or moderate income by the Secretary of Housing and Urban Development. The bill would provide that the gross income for an area may be determined by the use of estimates by the Secretary of Housing and Urban Development. Also, the bill would provide that the Secretary of Housing and Urban Development may take into consideration, in determining individuals of low or moderate income, (1) the size of the individual's family, (2) construction costs in the area, and (3) any other factor prevailing in the area.

Required period of targeting

The bill would provide that the 20 percent (15 percent in targeted areas) requirement must be met for the period beginning on the first day that the project is occupied until after the later of (1) ten years after the project is first occupied, (2) a date ending when 50 percent of the maturity of the bond has gone by, or (3) the date on which any section 8 assistance terminates.

Registration

The bill would repeal the registration requirement as it applies to tax-exempt industrial development bonds for multi-family housing.

Effective date

The amendments made by the bill would apply to obligations issued after the date of enactment.

Revenue effect

The bill is estimated to reduce fiscal year budget receipts by $1 million in 1982, $4 million in 1983, $9 million in 1984, $15 million in 1985, and $22 million in 1986.

PREPARED STATEMENT OF SENATOR MAX BAUCUS

Mr. Chairman, I want to commend you and your Committee for holding this hearing this morning. Last spring, I introduced one of the bills you are considering today—S. 608, which would allow individuals a deduction for expenses paid or incurred in connection with the adoption of a child.

All of us involved with the issue of adoption believe, I am sure, that promoting adoption by cutting its cost is an idea whose time has come. This is particularly true as we seriously consider ways to support, rather than interfere with, the building of strong and productive families for our nation.

It is very important, I believe, that we find a sensible approach to aid families who are willing to adopt this country's orphans families who may now be discouraged from doing so by some of the financial barriers they confront.

It is expecially important—and timely—in these austere times. Many human service programs have undergone substantial cuts. Two of them—Child Welfare Services and AFDC—provide adoption and foster care assistance. To thus provide a way—as this Committee is—for adoptive parents to share in the non-recurring costs of adoption through tax incentives is timely.

Again, Mr. Chairman, I commend the Committee's efforts on this matter, and offer my continued strong support of finding ways to encourage the adoption of children who might otherwise be left unwanted and unloved.

PREPARED STATEMENT OF SENATOR CARL LEVIN

Mr. Chairman, I want to thank you for this opportunity to express my support for H.R. 1348 introduced by Senator Sasser, which amends the Mortagage Subsidy Bond Tax Act of 1980. This legislation, which I have cosponsored, eases the restrictions contained in the 1980 Act on the use of the proceeds of tax-exempt mortgage bonds for housing. The restrictions have hamstrung the states and localities which in the past have used these bonds to finance their housing programs. These bond programs had enabled individuals to buy homes at below market interest rates with low downpayments. Now, the effective shutting down of state and local bond programs comes at a time when the Federal Reserve is pursuing a tight money policy, which has produced record high interest rates and have made home sales plummet.

I hear from home builders and realtors from Michigan every day that their businesses are on the brink of disaster. They are not and should not be comforted by promises that interest rates will come down and their businesses will revive in the long run. Mr. Chairman, the way things are going for them, they won't make it to the long run. So, it is urgent that something be done now.

The legislation introduced by Senator Sasser will provide some help. Most importantly, it will amend the requirement in the 1980 law that for a mortgage bond issue to qualify for tax-exempt status, 95 percent of the proceeds of the issue must go to mortgages which satisfy all the requirements of the Act. Under current law, if the bond issue were ever to fall below 95 percent compliance, and even if noncomplying loans were corrected, the entire bond issue would lose its tax-exempt status. The Sasser bill provides that a showing that the issuing authority has tried in good faith to satisfy all the requirements will cure a failure to meet any particular requirement if the failure is corrected within a reasonable period of time. Bondholders would be able to rely on the issuer's good faith convenant as to compliance. This change seems to me to strike a reasonable balance, allowing the bond programs sufficient flexibility to operate within the context of an overall structure.

The Sasser bill also removes the requirement that mortgage subsidy bonds be registered. This requirement has made these bonds less desirable and less liquid than any other municipal bond. Bonds for pollution control or for sewage disposal facilities are not subject to any registration requirement, for example. It adds an estimated .5 percent to the interest rate which the issuing authority must pay to the bond purchaser and, in turn, pass on to the homebuyer. It simply makes no sense to keep a requirement in the law which both puts these bonds at a competitive disadvantage and increases costs to consumers at the same time.

In addition, S. 1348 amends the requirement in the 1980 law that the effective rate on mortgages financed by these bonds not exceed the yield paid to the purchasers of these bonds by more than 1 percent. Because of this provision, the Michigan State Housing Development Authority would have to market its bonds at a loss. For example, it is estimated that the Authority would lose between $500,000 and $1,000,000 in order to sell a $50 million bond issue. The Sasser bill would increase this spread to 1½ percent, which housing agencies have indicated would be adequate to make these bond programs self-supporting.

These changes, along with several others specified in the Sasser bill, will revitalize the mortgage subsidy bond programs across the nation and contribute toward stimulating the housing industry. They will help to make the prospect of homeownership by Americans more than just a dream.

STATEMENT OF HON. MARK O. HATFIELD, U.S. SENATOR FROM THE STATE OF OREGON

Senator HATFIELD. Thank you, Mr. Chairman. I am pleased that your subcommittee has chosen to hold hearings on the issue of providing tax deductions for adoption expenses. I would like to especially commend Senator Jepsen for his diligence in pursuing this legislation and I want to indicate my total support for S. 99.

Mr. Chairman, somewhere—I suspect that it began in the 1930's or the 1940's—we began to get the idea that this was the Government's job to take care of children. As churches and nonprofit organizations and private citizens failed to take up the slack due to the heavy demands of the great depression, Government stepped in with the best of intentions to provide institutions to care for these children.

Today, we have an elaborate institutional network that the Federal Government provides for foster children that cost over $400 million. It seems that the foster care program developed an inertia of its own that is expensive and oftentimes insensitive to the child's right to a permanent and loving home. Until recently we did very little to encourage adoptions and the permanent placement of a child in a home. This committee has shown sensitivity to the foster care problem by enacting H.R. 3434 in the 96th Congress and by approving Senator Jepsen's amendment to the President's tax package that provided a tax incentive for adopting a special needs child. However, we need to go a step further and broaden the incentive to include both domestic and international adoptions. We need to be aware of the enormous cost of an adoption because the $4 to $6,000 in fees will generally exceed 20 percent of the average adoptive family's income. These costs are not deductible, and few employers provide any help in their health plans.

Those innovative companies, such as IBM, which offset a portion of the employee's adoption costs, are discouraged from doing so by the current tax code which treats the aid as taxable income.

Senator Metzenbaum's legislation, S. 1479, solves this problem; it makes the company-provided benefits nontaxable.

Mr. Chairman, I have two concerns about the issue discussed today. First, I am concerned that international adoptions might be excluded from any legislation approved by this committee. For many families, an international adoption is the only alternative, and it is fraught with risks, significant medical costs and health problems of the child—travel costs, additional agency and legal obstacles—and this makes it very difficult for many families, for these costs range sometimes from $4,000 to $8,000.

Since only 5,000 international adoptions occur each year, the revenue loss would not exceed $3 million a year. I fail to see the difference between a needy child in India that is sent to an American family by Mother Theresa and a child that happens to be born in America. While I agree that we have a special responsibility to American-born children, we need to remember that existing law, agency practices and a typical 3-year waiting list for U.S. children make a foreign adoption a last resort. Due to much higher costs in a foreign adoption, an overall cap on allowable expenses will continue to provide greater incentives to adopt a U.S. born child.

Second, I am concerned about efforts to limit the allowable adoptions to agency placements. We should proceed very carefully in this area because of the sharp disagreements in the social work field over the issue of independent adoptions. I do not wish to take sides on the issue, but want to point out that the individual State legislatures are struggling to achieve a solution to the problem. I believe that we should be reluctant to tip the scales in either direction by making a change in the Tax Code. The issue properly belongs in the State legislatures as a matter of family law under their police powers. As long as the adoption violates no State or Federal law, I believe the adoption expenses should be deductible.

In summary, I strongly endorse the objectives of Senator Jepsen's legislation. I believe it would be helpful to read the motto of Holt International, a reknowned adoption agency, located in Eugene, Oreg.: "Every child of whatever nation or race has the right to grow up with parents of his own. The silent call of homeless children to all men of good will to see that neither apathy nor prejudice, neither custom nor geographic boundary, shall prevent these children from receiving this God-given right."

Mr. Chairman, I appreciate the opportunity to testify in support of Senator Jepsen's bill, and when the opportunity for a second tax bill presents itself I hope the committee will see fit to approve this legislation. Thank you very much.

Senator **PACKWOOD**. Thank you very much, Senator. Obviously, you and I are very, very experienced in international adoptions with the success of the Holt agency for a long, long period of time.

Senator **HATFIELD**. One of the first.

[The prepared statement of Senator Mark O. Hatfield, of Oregon follows:]

PREPARED STATEMENT OF SENATOR MARK O. HATFIELD

Mr. Chairman, I am pleased that you have chosen to hold hearings on S. 425, which we jointly introduced earlier in the year as part of the Senate Finance Committee's review of the Mortgage Subsidy Bond Tax Act of 1980. The passage of this Act clearly demonstrates perils of utilizing the reconciliation process, because the Congress delegates tasks of re-writing basic laws to a few key legislators, thereby short-circuiting the careful review of both Houses of Congress.

Although the House passed H.R. 5741 in the spring of 1979, the bill did not become law until it was attached to the reconciliation measure in the lame duck session of the 96th Congress, without ever being considered by the full Senate. By attaching this measure to the Omnibus Reconciliation Act, several Senators, including myself, were never given the opportunity of having our own bills carefully considered.

The final legislation enacted in December of 1980 created several serious problems for the Oregon Veterans Home Loan Program, because of the failure of the Congress to specify transition rules for state veteran programs. Applicants who had received letters of commitment or had incurred financial obligations in anticipation of VA loans were cut off by the requirements of the new law that became effective on January 1, 1981. Specifically, the new requirement shut down loans to veterans who desired to finance a farm with an adjoining residence and all loans made to refinance an existing mortgage or to make substantial improvements on a residence. Hundreds of affected Oregon veterans contacted their Congressional delegation and complained bitterly about the retroactive provisions in the new law.

Senator Packwood and I introduced S. 425 as a short-term solution that would have exempted the pending bond sales from the new law. We were successful in attaching a slightly different version of this legislation to the Senate tax bill, but unfortunately, the Conference Committee dropped the measure. Although the passage of time now makes the short-term legislation somewhat moot, significant problems remain as a result of the Act.

First, under regulations recently issued by the Treasury Department, temporary initial financing was defined as contracts lasting no longer than six months. If longer, the contract would be termed a refinance, and would be an ineligible use of tax-exempt proceeds. The problem with this strict rule is in the peculiar nature of the Oregon program, and has been made more acute by the current housing slump in Oregon. Oregon veterans typically have their applications accepted by the VA, and a contract then is pursued by the buyer to hold the veteran over until the Oregon VA goes to the bond market and successfully sells the bond. Due to the scarcity of mortgage money, most deals involved some form of owner financing on a contract. Due to the fact that the VA program accepts applications before the bond sale is made, and due to the existing tight mortgage market, the six-month rule proposed by the Treasury Department unduly restricts the applicant from utilizing the benefits of the program. The Congress recently extended the 18-month rollover period for an individual who sells a residence and re-invests in a new one to 24 months due to the housing slump. The Oregon Department of Veterans' Affairs has suggested a 24-month rule for temporary initial financing as a possible suggestion and I urge the Committee to carefully consider this proposal.

Second, this Committee should also look into the rationale behind including state veterans programs in the restrictions imposed by public law 96–499. Former Chairman of the House Ways and Means Committee, Al Ullman, repeatedly assured the Oregon Veterans Affairs Department officials that their programs would be unaffected by his proposed legislation. His initial bill, H.R. 3712 and a later version, H.R. 5741, and the final legislation enacted, all basically excluded state veterans programs from the restrictions imposed upon mortgage revenue bonds. Specifically, a sunset provision applies to mortgage revenue bonds as well as purchase price and other limitations, but not to veterans programs. However, even though veterans programs were exempted from these requirements, they were subjected to new requirements of registration, of funding residences, and to financing new mortgages. For whatever reason, the Finance and Ways and Means Committees never received input from affected state veterans programs on the likely effect of these new restrictions. The hearing's record is full of testimony about the abuses and wonders of mortgage revenue bonds, but there is no mention of how Representative Ullman's bill would impact on state veterans programs.

It is also instructive to note that the tremendous growth in tax-exempt bonds for housing was occurring in mortgage revenue bonds, not state veterans housing programs. While mortgage bonds were largely confined to multi-family rental units in the early 1970's, these bonds proliferated in the late 1970's for single-family residences. The amounts grew from $36 million in 1971 to $8.7 billion in 1979, and were expected to reach $16.7 billion by 1985. As a percentage of total state and local tax-exempt financing, housing bonds increased from 7 percent in 1978 to 26 percent in 1979. Obviously, the Congress was legitimately concerned with the explosion of mortgage revenue bonds. However, the amount of veterans bonds issued over the years has remained largely constant.

It is my suggestion, Mr. Chairman, that we continue to put overall limits on the amount of tax-exempt bonds that can be issued by the states. In fact, it might even be desirable to impose stricter limits on the amounts because of the crowded market for tax-exempt issues that threaten the funding of necessary services such as roads, prisons, schools, sewer systems, and hospitals. However, I would strongly urge the Committee to consider exempting the state veterans programs from the restrictions imposed on farm loans and refinancing.

The present law contains an urban bias that allows veterans programs to fund expensive metropolitan condominiums, but disallows an Oregon veteran who chooses to live on 15 acres, for example, with a mobile home, from receiving any VA loans. The law also strikes against one who is not a full-time farmer, but chooses to raise his family in a rural atmosphere and conduct limited farming operations. Given the overall restrictions on the amount of tax-exempt financing allowed for each state, I see no reason why the federal government should tell a state how it should portion its tax-exempt funds.

The new law's prohibition on refinancing hits those individuals who substantially renovate their homes, depend upon short-term installment contracts, or buy a home but must wait for the requisite number of years of residence before receiving a veterans loan. While legitimate arguments can be made to restrict eligible uses of tax-exempt bonds to first-time homebuyers and individuals who cannot presently afford an existing mortgage, I believe that it would be prudent to give the local state legislatures the flexibility to make these political decisions as to which veterans should benefit from the program. The Congressional interest should focus upon limiting the overall amount of tax-exempt financing in order to remain consistent with the budget and crowded nature of the bond market.

There is no doubt that the Oregon State Veterans Home Loan Program must adapt to the new realities of financing tax-exempt issues. While interest rates, eligibility standards, and price ceilings may need to be revised in order to adjust to a difficult bond market, I believe we should leave these matters to the discretion of the local state legislature and local officials as much as possible. Imposing an overall limit on state tax-exempt financing makes sense if we wish to give the state and local governments a maximum degree of flexibility in designing tax-exempt housing programs. Such a step would recognize the beauty of programs which have been run smoothly and successfully for over 35 years.

Since 1945, the Oregon Veterans Home Loan Program has benefitted over 233,970 veterans for a total of $6 billion in mortgage money. The average income of the veteran is $28,000 a year, and there are limits on the amount of money that a veteran can borrow under the program. The program has been profitable over the years and has consistently obtained a top rating on its bond issues. It is a well-run program, with no defaults by individuals, and it has achieved national recognition for its ability to provide worthwhile benefits at a minimum of administrative expense.

In summary, I would strongly urge the Committee to consider the suggestions made by the Director of the Oregon Veterans Affairs Department, General Staryl Austin, as part of its review of the Mortgage Subsidy Bond Act of 1980. It is my hope that the Congress would retain overall limits on the amount of allowable tax-exempt financing, but would substantially exempt the state veterans programs from the Act. Mr. Chairman, I appreciate the opportunity to testify on the issue of veterans' bonds for housing.

Senator **Packwood**. One of the first.

I will take the other Senators in order of seniority. I will take Senator Metzenbaum next and then Senator Jepsen.

STATEMENT OF HON. HOWARD METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO

Senator **Metzenbaum**. I thank you. But if Senator Jepsen is under pressure of time and needs to leave, I will yield to him.

Senator **Jepsen**. No. I yield to the Senator

Senator **Metzenbaum**. Thank you very much. I appreciate it.

Mr. Chairman, I am very pleased to have an opportunity to appear before your committee and to appear with some of my very distinguished colleagues, who support generally the same objectives, although perhaps with some differing detail.

Several months ago I introduced the Stronger American Family Act of 1981, legislation that was designed to provide the families of this country with practical assistance in dealing with the real world problems of the 1980's.

I am particularly pleased that an important part of that package has already been enacted in the form of the Metzenbaum-Hawkins child care amendment, and which the distinguished Senator from Florida joined me in offering to the 1981 tax bill.

[The prepared statement of Senator Metzenbaum follows:]

PREPARED STATEMENT OF SENATOR HOWARD M. METZENBAUM

Mr. Chairman, several months ago, I introduced the Stronger American Family Act of 1981, legislation that was designed to provide the families of this country with practical assistance in dealing with the real world problems of the 1980's.

I am pleased that an important part of that package has already been enacted in the form of the Metzenbaum-Hawkins child care amendment to the 1981 tax bill. That amendment, whose passage owed a great deal to your support, Mr. Chairman, and that of Senator Durenberger, substantially increases the day care tax credits available to working families. It also provides incentives to businesses to establish day care facilities for employees, and it makes the credit available for the care of elderly and disabled household members.

Today, Mr. Chairman, this committee is considering another matter of concern embodied in the Stronger American Family Act—and that is how best to assist those who are willing to take into their families through adoption the many thousands of American children who desperately need loving homes.

Although the government has not kept adoption statistics since 1975, recent reports place the number of adoptions at around 100,000 per year. In fact, the number of adoptions in this country has declined steadily since 1970 when a record 175,000 children were adopted. And since 1960, the number of children in foster care has doubled to approximately 500,000.

The issue, Mr. Chairman, is stability for children and their family relationship. Congress has recognized this problem in the past. We responded with the Child Abuse Prevention and Treatment and Adoption Reform Act of 1978, and the Adoption Assistance and Child Welfare Act of 1980. These acts increased funding for child welfare services and required states to move in the direction of making foster care what it has always been intended to be a temporary solution.

Yet despite these congressional efforts, adoption is still not a reality for far too many children. Earlier this year, The New York Times reported that fewer than 20 percent of the children available for legal adoption in New York's publicly assisted agencies were actually placed. The Washington Post reported that the District of Columbia's foster care system is overburdened and understaffed.

And unfortunately, the major federal program intended to encourage the placement of older, handicapped, and minority children has been cut by more than half.

The adoption provisions of my Stronger American Family package, would permit adoptive families to claim the costs of adoption as a tax deduction—that I believe is a small, but helpful, gesture by this nation to families who take as their own children who need homes.

In addition, my bill takes note of the fact that at least 20 major companies have in recent years begun to assist their employees with the costs incurred in adopting children. IBM, for example, has had an adoption assistance program since 1972, and has averaged approximately 350 to 400 claims per year. The SmithKline Corporation paid employees $400 per adoption at the time it began its program. Now, SmithKline pays $1,000 and intends to increase the benefit each year until the amount of the benefit is comparable to the cost of a normal obstetric delivery.

More corporations should be encouraged to adopt such socially responsible policies. But unfortunately, they are today discouraged by the tax code from doing so. Adoption assistance is considered regular income for tax purposes, and so companies providing it must incur the costs of social security taxes and an extra paperwork burden. That should not be—and my bill corrects the inequity by excluding adoption benefits from employee income.

Mr. Chairman, I do not believe that we can transfer responsibilities from the Federal Government to the private sector without taking at least some steps to protect vulnerable people.

The adoption provisions of the Stronger American Families Act are a small step in that direction, and I hope that the subcommittee will give this approach its fullest consideration.

Senator **Metzenbaum**. Now that amendment, whose passage owed a great deal to your support, Mr. Chairman—and we feel very strongly that without your assistance it would not have been or it certainly very well might not have been—as well as that of Senator Durenberger, substantially increases the day care tax credits available to working families. It also provides incentives to businesses to establish day care facilities for employees, and it makes the credit available for the care of elderly and disabled members. And I cannot think of any subject that really is more deserving of our attention here in the Congress than this, the issue of the family relationship.

Today, the committee is considering another matter of concern that is embodied in my Stronger American Family Act, and that is how best to assist those who are willing to take into their families through adoption many thousands of American children who desperately need loving homes. Actually, as a matter of fact, the Government has not kept adoption statistics since 1975. And I am not exactly sure why that is. But recent reports place the number of adoptions at around 100,000 per year. In fact, the number of adoptions in this country has declined steadily since 1970 when a record 175,000 children were adopted. And since 1960, the number of children in foster care has doubled to approximately 500,000.

Mr. Chairman, I think that the whole issue here has to do with the stability of the family relationship. Not to negate the value of foster care programs, but to emphasize that that family that adopts a child develops a kind of relationship with the child, between the child and the parent, that is so meaningful that it truly relates directly to the future of those children, and I certainly believe it adds an extra degree of love and affection and concern on the part of the adopting parents as well. And I think that anything that we here can do to be of assistance along this line is so important.

Now Congress has recognized this problem in the past. We responded with the Child Abuse Prevention and Treatment and Adoption Reform Act of 1978, and the Adoption Assistance and Child Welfare Act of 1980. These acts increased funding for child welfare services and required States to move in the direction of making foster care what it has always been intended to be, a temporary solution. Foster care, great; adoption, the ultimate objective.

Despite these congressional efforts, adoption is still not a reality for too many children. Earlier this year, the New York Times reported that fewer than 20 percent—fewer than 20 percent—of the children available for legal adoption in New York's publicly assisted agencies were actually placed. And the Washington Post reported that the District of Columbia's foster care system is overburdened and understaffed. What a sad commentary when we are so concerned about crime in the streets, about the problems of America, that in this area where we can have a positive impact that we find that the foster care system is overburdened and understaffed.

And, unfortunately, the major Federal program intended to encourage the placement of older, handicapped, and minority children has actually been cut by more than half. The adoption provisions of my stronger American family package would permit adoptive families to claim the cost of adoption as a tax deduction. Frankly, I believe that is a small, but helpful, gesture by this Nation to families who take as their own children who need homes. But it would not be so broad based that it would provide funding or provide tax deductions for those who may deal in what I call the adoption rings, or those who traffic in this business. It would be required that to take the deduction you would have to go through the recognized welfare agencies, the social agencies. And then if you had legal expenses in connection with that, they also could be deducted. But the fact is that there would be limits and there would be a sense of propriety about it.

In addition, my bill takes note of the fact that at least 20 major companies have in recent years begun to assist their employees with the costs incurred in adopting children. IBM, for example, has had an adoption assistance program since 1972, and has averaged approximately 350 to 400 claims per year. The SmithKline Corp. paid employees $400 per adoption at the time it began its program. And now SmithKline pays $1,000 and intends to increase the benefit each year until the amount of the benefit is comparable to the cost of a normal obstetric delivery.

Frankly, more corporations should be encouraged to adopt such socially responsible policies. But, unfortunately, our tax code does the opposite. They are, today, discouraged by the tax code from helping in these adoptive costs. Adoption assistance is considered regular income for tax purposes, and so companies providing it must incur the costs of social security taxes and the extra paperwork burden as well. That should not be. And my bill corrects the inequity by excluding adoption benefits from employee income.

Mr. Chairman, I do not believe that we can transfer responsibilities from the Federal Government to the private sector without at least taking some steps to protect vulnerable people. The adoption provisions of the Stronger American Families Act are a small step in that direction, and I hope that the subcommittee will give this approach its fullest consideration.

I should point out to the chairman that the total costs involved are very modest. We are probably talking about $38 to $40 million a year. And that is without the offsetting advantages of the reductions in foster care cost. So we are talking about a rather insignificant amount of money.

I would also like to introduce in the record a letter from Xerox Corp. in which they say "Xerox is particularly interested in this bill and wholeheartedly endorses it in light of our adoption assistance plan"; a letter from SmithKline Corp. in which they write: "I am writing to you to give my endorsement and that of my company to your bill"; a letter from Fel-Pro endorsing my bill, as well as an article from the Houston Post concerning firms that offer benefits to adoptive parents; one from the New York Times about company benefits; and several other articles that I think bear on this subject.

[The material follows:]

July 16, 1981

Mr. David Starr
Office of Senator Metzenbaum
347 Russell Senate Office Building
Washington, D.C. 20510

Dear Mr. Starr:

It has come to my attention through the National Committee for Adoption that a bill is currently being proposed that would allow the exclusion of adoption assistance plan payments from an individual's gross income.

Xerox is particularly interested in this bill and wholeheartedly endorses it in light of our Adoption Assistance Plan. This plan, which covers all U.S. employees was implemented in October of 1979. Since that time it has provided benefit payments totalling $99,610 to 118 employees. These payments have always been included in employees income and therefore the total amount reimbursed has been reduced.

I've enclosed a copy of the policy governing the Plan along with an article from our house organ, the Xerox World, which depicts the reaction of one of our employees helped by the Plan. These feelings are universal among employees who have been assisted.

We feel the passage of this bill would be very beneficial to our employees.

Sincerely,

Sharon D Diehl

Sharon D. Diehl
Benefits Operations Manager

SDD/ca

Attachment

c: R. Scheerschmidt

With a little help from Xerox...

It's A New Member of the Family

Ken Laffal/NYT PICTURES

All out for a walk: Eric and Barbara Perez with their son Christopher, daughter Holly, and—high on his father's shoulders—newly adopted son Curtis.

Curtis Perez is the newest member of the family of Eric and Barbara Perez and their two children, Holly and Chris. He joined them 8 months ago at the advanced age of 2.

Here's how it all came about.

Eric, who is manager of pricing and strategy analysis in Stamford, is a native of the Philippines. He came to the U.S. in 1965, took a graduate degree from Carnegie-Mellon University and went to work for Xerox in Rochester, where he met and married Barbara.

In the natural course of events, the family grew—first to three and then to four. But, when Eric and his wife wanted a third child, for medical reasons they decided to adopt. They also decided to adopt a boy of mixed racial background, to fit in with their children's heritage.

As it happened, their adoption plans coincided with the new Xerox Adoption Assistance Program, begun in October 1979, and they were among the first Xerox families to take advantage of it.

Under the best of circumstances, adopting a child is a lengthy process, involving volumes of correspondence and paperwork. The Perez family chose to work with a small agency which had worked with orphanages in the Philippines before, and that helped mightily. But even so, the distance involved made the process seem endless.

Eric and Barbara took great care to include their two children, Holly and Chris, in all the plans and the progress of the big event. "The children became very impatient to see their new baby brother," recalls Eric, "but the day finally arrived. All the waiting was over."

According to Eric, young Curtis is very much a part of the Perez family. "He's a very happy kid and has contributed a great deal to the household. The children love to show him off to their friends. Everyone has benefitted."

Curtis was well on his way to adoption before the Xerox Adoption Assistance Program came along, "but it certainly helped," Eric says. "We found the program was very well run, and the whole experience has been most rewarding."

As a footnote to this story, Sharon Diehl of our corporate benefits staff reports that thus far over 50 requests for adoption aid have been processed.

"We're delighted with the progress of the program so far," she says, "and we expect it will continue to grow."■

SmithKline
CORPORATION

September 30, 1981

Honorable Howard M. Metzenbaum
United States Senate
347 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Metzenbaum:

It is my understanding that you are sponsoring a piece of legislation which would provide tax exemption for benefits paid to employees through an employer's Adoption Assistance Program. I am writing to you to give my endorsement and that of my company to your bill.

SmithKline initiated its program in 1973. Our purpose was to recognize, in part, the financial needs of the adoptive parent in the same spirit in which we meet the needs of a natural parent through our medical insurance. Inasmuch as the latter benefit is tax free to the employee, it would seem equitable that the adoption benefit should receive the same consideration.

Although our present benefit of $1,000 is less than the comparable benefit paid for the average normal birth, we are increasing the benefit each year to eventually reach parity.

I should point out that this is not a major program or issue with us. We average about 6 claims per year. I do feel however that it is of considerable concern to the adopting parent to have a significant portion of their benefit taken from them by the government.

I wish you success in pursuing this issue.

Sincerely,

Robert S. Bursch

ROBERT S. BURSCH
Manager, Employee
Benefits Administration

RSB:MAS

cc: A. Hohwald-Davis

FEL-PRO
GASKETS, SEALING PRODUCTS, SPECIALIZED LUBRICANTS

June 19, 1981

David Starr
Office of Senator Metzenbaum
347 Russell Senate Office Building
Washington, D. C. 20510

Gentlemen:

Our company strongly endorses your bill making adoption benefits non-taxable for employees and employers.

Since 1973 we have offered a fringe benefit of $500.00 reimbursement to our employees who are adopting a child. Approximately 20 employees have used this benefit since it was introduced.

Sincerely yours,

FELT PRODUCTS MFG. CO.

Robert C. O'Keefe
Industrial Relations Manager

RCOK/nk

The Houston Post
Tues., June 9, 1981 B

Firms offer benefits to adoptive parents

Glen Rainwater and adopted son Sean
— Post photo by Roger Powers

By BARBARA McINTOSH
Post Reporter

Two months after the phone rang, Glen and Zoe Rainwater were the proud parents of a newborn son.

Nothing could have been further from their minds the day it happened. They had just finished packing the car for a weekend at the lake. Suddenly the doctor called to ask them if they still wanted to adopt a child. He knew of a pregnant 17-year-old who was not going to keep her baby.

It took only two hours to decide. The answer was emphatically yes.

Two years later, the Rainwaters are still awed by how everything turned out. They'd almost resigned themselves to never having a child together. Now, Sean, like the missing piece of a puzzle, perfectly completes their family picture, which includes Glen's 12-year-old son, Shane, from a previous marriage.

Mischievous Sean, with his blond hair and brown eyes, even resembles the three of them.

ALTHOUGH THEIR UNION seems something meant to be, it didn't come without a struggle. Until 3-day-old Sean was actually put in their arms, there was always the chance his natural mother might change her mind. The Rainwaters also had to pay more than $2,000 in medical, legal and court fees to make the adoption legal.

To Glen's surprise, the company he works for stepped in to help. Pitney-Bowes is one of the small but growing number of companies that pays benefits to their employees who adopt. The Rainwaters qualified for $850 in compensation and received a check of almost $700 after taxes. Glen, who is a Houston sales manager for the business-machines company, hadn't even realized the benefit existed.

XEROX IS ANOTHER major corporation that offers this unusual benefit. Robert A. Dibenedetto and his wife, Helen, adopted a daughter in February 1980. Private agency costs ran approximately $4,000. Xerox awarded Dibenedetto, a Houston sales manager, $1,000 before taxes.

"I had been told about the benefit," he says, "but almost forgotten because I assumed my wife would get pregnant. She didn't, and when we adopted it came out of the blue to help. It's an excellent benefit."

Approximately 30 companies nationwide have added such adoption clauses to their overall employee programs. Ranging in maximum amounts allotted from $75 to $2,250, most firms say they extend this service because adoptive parents are not covered by the longstanding maternity benefits that help other employees when they have a child.

THERE IS PERHAPS a deeper rationale behind adoption benefits, though. In a time when worker productivity is slumping and job dissatisfaction rising, many companies believe it pays in the long run to keep employees happy. The trend in corporate benefits may well be "doing more than you have to do."

For example, some firms offer cash bonuses such as savings accounts for employees' new babies and cash gifts for weddings and high school graduations. Others pay employees' car insurance and give vacation bonuses.

A study on adoption benefits conducted by the research staff of Hewitt Associates concluded: "The amount of positive publicity and good will generated by an adoption award may far exceed the actual expense of the benefit."

SINCE PITNEY-BOWES added the benefit in 1974, approximately 77 of its employees have received compensation. Other companies jumping on this benefit's bandwagon include Hallmark Cards, IBM, Foote, Cone and Belding, Eli Lilly, Syntex and Abbott Laboratories.

IBM began its program in 1972 and has assisted 2,000 employees nationwide. A special plus of its plan is that adoptive parents are reimbursed when the child is placed in their home, not when the adoption is legally finalized. Months often separate the two events.

Most of the firms' plans — including IBM — reimburse employees a median amount of $1,000 for approved expenses. Those frequently covered include public or private agency fees and court and legal fees. Some companies also help pay for foreign adoptions, medical examination costs and temporary foster-care charges.

Pitney-Bowes is one of those that will help pay for pregnancy expenses of the natural mother. The Rainwaters were delighted because they paid for all of Sean's natural mother's hospital expenses, but had no regular agency fee with which to contend.

FOREIGN ADOPTIONS are also covered by Pitney-Bowes. One couple in Stratford, Conn., was aided when they flew to Colombia to adopt so they wouldn't have to wait three years for placement through a U.S. agency. They received $800, the full amount of compensation the company then allowed.

Of Xerox's 46,000 employees nationwide, about 200 have used the up-to-$1,000 adoption benefit since it was instituted in 1979. For example, Jeffrey Jackson and his wife received the entire $600 it took to adopt his 2-year-old daughter. He is a Xerox serviceman in Lansing, Mich.

"Our employees are really grateful," Terry Dillman, a Xerox spokesman, says. "It's just a nice little extra."

BY ALL REPORTS, the adoption benefit is creating few, if any, problems. In a study of 14 companies that offer it, Hewitt Associates found it was working beautifully. The only [illegible] seemed [illegible] employees. [illegible] and a few, some are not aware it exists.

No one believes knowledge of the benefit will lead to someone adopting a child, however.

"No way," Dibenedetto says when asked if the money he received from Xerox was a determining factor in his daughter's adoption. "The benefits aren't high enough to get someone to do that."

Sitting in his Alief home with Sean firmly settled in his lap, Rainwater says he understands why Pitney-Bowes extends the benefit. "The cost of hiring, schooling and orienting a new employee can cost from $10,000 to $[illegible] in the first two months," he says. "It just makes sense for Pitney-Bowes to try to keep the people they already have. The way to do that is to keep them happy. A good benefit program helps do that."

Zoe agrees. She says the unexpected adoption benefit came at a time when they were struggling with a new house payment and a loan they'd taken out to cover the cost of adopting Sean. "When we heard about it, it was like someone had looked down and said, 'OK, you've suffered enough. Now here's something to help you.'"

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THE NEW YORK TIMES, SUNDAY, JUNE 8, 1980

p64 section 1

For Adoptive Parents, Company Benefits

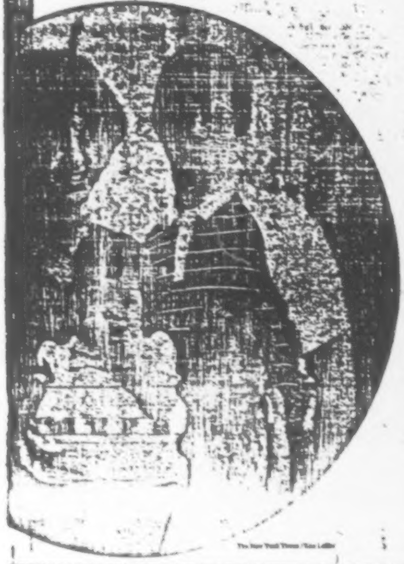
By JUDY KLEMESRUD

When Patrick and Kathy Donahue of Stratford, Conn., decided they wanted to adopt a child, they flew to Colombia rather than waiting the three years they were told it would take to adopt a child through an American agency. They adopted their first daughter in 1977, their second in 1979.

Today, Kyla is 3 years old and Katie is [illegible] months. Because of the travel to Bogotá and the legal and agency fees involved, Mr. Donahue estimates it cost him $[illegible] to adopt each of the girls — more than double the cost of an average adoption through an American agency.

But the costs were offset somewhat by an adoption benefit that Mr. Donahue's employer, Pitney-Bowes, paid him for each of the girls. At the time of Kyla's adoption, it was $[illegible], by the time of Katie's adoption, it had risen to $[illegible], where it stands today.

Pitney-Bowes, which has headquarters in Stamford, Conn., is one of the growing number of American corporations that now offer adoption benefits as well as the longstanding maternity benefits paid to employees who have children born to them. Others include I.B.M., Xerox, Hallmark Cards Inc. and Foote Cone & Belding Communications.



The New York Times / [illegible]

The benefits generally range from $[illegible] to $[illegible] per child, but some companies pay the same amount that an employee would receive through a medical plan for a normal delivery. In most cases, taxes are withheld from the check containing the adoption benefit.

At I.B.M., [illegible] percent of the legal, maternity and agency fees involved in an adoption are reimbursed, with a maximum payment of $[illegible], a company spokesman said. Since I.B.M. added adoption benefits in 1972, more than [illegible] couples have been reimbursed, the spokesman added.

Xerox and Hallmark both pay adoption expenses up to a maximum of $[illegible]. Xerox added adoption benefits last October, Hallmark this past February. Foote Cone and Belding, which has offered an adoption benefit for about 10 years, reimburses employees for the same amount of money they would receive for a normal delivery, "around $[illegible] or $[illegible]," a company spokesman said.

Why Adoption Benefits Are Paid

Why are more and more corporations paying adoption benefits? "Because they want to make their employees happy," said Helen Connors, administrator of the program for Pitney-Bowes, which has paid benefits to 73 couples since 1974. "Corporations are very family-minded, and I guess they feel that if their employees can't have children on their own, then they should help pay for adoption."

Although all of the adopting couples who were interviewed said they were thankful for the adoption benefit, none said that the money had inspired them to go out and adopt a child.

"The benefit certainly helped and it was a very nice plus," said Mr. Donahue, [illegible], director of field office administration at Pitney-Bowes, "but we would have adopted anyway."

Eric Perez, of Stamford, the 37-year-old manager of pricing and strategy analysis for Xerox, recently received a $[illegible] adoption benefit from his company for his 3-year-old son, Curtis, who was born in the Philippines.

"My wife and I have two biological children," Mr. Perez said, "and when we decided we wanted a third child we thought about adoption for several reasons, mainly because my wife had had difficult pregnancies and didn't want to go through it again."

Mr. Perez, who immigrated to this country from the Philippines in 1964 to study business administration at Carnegie-Mellon University, quite naturally favored a child from his native country. So he and his wife, Barbara, contacted the International Alliance for Children, a Connecticut agency that arranges foreign adoptions. About a year later, Curtis was on his way to the United States.

Mr. Perez, whose other children are Holly, 9 years old, and Christopher, [illegible], estimated that it cost him $[illegible] to adopt Curtis. Commenting on his $[illegible] adoption benefit, he said: "It was really helpful, considering how expensive adoption is. Frankly, I don't understand the company's motivation when you come right down to it. It's not related to anything that has to do with your work — but it's certainly a nice thing for them to do."

A Three-Year Wait

When Daniel and Suzanne DeLeonardo of Norwalk, Conn., learned they could not have children, they applied to adopt a child through Catholic Charities of Bridgeport, Conn. Because of the shortage of adoptable children in this country, it took three years before Daniel Jr., now 2, arrived in their home.

"He's Spanish, Italian, American Indian and Puerto Rican, and he looks just like my husband's side of the family," said Mrs. DeLeonardo, whose husband is of Italian descent.

Mrs. DeLeonardo, [illegible], a bookkeeper for Pitney-Bowes, received an $[illegible] adoption benefit which, she said, came to $[illegible] after taxes. She said she used it to pay the agency the third and final payment of the $[illegible] it cost to adopt Daniel Jr.

"My agency had never heard of a company helping out before," she said. "They just couldn't believe it."

Mrs. DeLeonardo said that in addition to the adoption benefit, she was allowed to stay at home with her son for four months during which her job was held for her, although she received no pay. Her medical and dental insurance were also continued during this time, she said.

The DeLeonardos recently applied to adopt a second child through Catholic Charities of Bridgeport, and if they are successful, they will receive a second $[illegible] adoption benefit.

"I think it's wonderful," she said. "Just because I can't have children I don't feel I should be forgotten and not have a benefit. There's really no difference if you have a child or adopt one, and if I had given birth I know I would have been taken care of."

Adopted a Relative's Child

Most companies that offer adoption benefits also pay when an employee adopts a spouse's or relative's child. Walter J. McCarty, 43, of Staten Island, a salesman for Pitney-Bowes in New York, recently received an $[illegible] benefit after he and his wife, Eileen, adopted their 8-year-old niece, Michele, following the death of the girl's mother.

Mr. McCarty, who is also the father of three biological children aged 21, 18 and 17, estimated that Michele's adoption cost him around $[illegible] in legal fees and in time lost from his job.

"I'm a commissioned salesman, and [illegible] I work, I don't eat," he explained. "The adoption benefit offset many things, and made the expense a little less bothersome."

A

Low Cost, Employee Goodwill Persuade Employers To Introduce A Variety Of Adoption Benefits

Since 1970, adoption benefits have become more popular, and the consulting firm of Hewitt Associates recently surveyed 14 companies that have some form of adoption benefits. The companies are Abbott Laboratories; Baxter Travenol Laboratories; Felt Products Manufacturing Co.; Foote, Cone and Belding Communications; Hallmark Cards, Inc.; IBM; S. C. Johnson & Son; Eli Lilly and Co.; Pitney Bowes; G. D. Searle & Co.; SmithKline Corp.; Smith Kline & French Laboratories; Syntex Corp.; and Xerox Corp.

Generally, companies provide adoption benefits because people who adopt do not receive pregnancy benefits but may incur considerable expenses through adoption. Additionally, the infrequency of adoptions makes the benefits very low cost compared to other types of benefits.

All 14 plans covered all employees. Thirteen of the plans were started in 1970 or after; one dates from the 1950s. Eligibility is dependent upon a period of service or enrollment in the health insurance program in some of the programs.

Method Of Funding

The most common funding method is through general assets (11 plans), although three companies fund the benefit through the medical plan, restricting payment to medical expenses. Eleven plans also pay the covered expenses after the adoption is final; one pays as expenses are incurred, one pays after the child's birth and if prior agreement is documented, and one pays when the child is placed in the adoptive home.

The problems involved with adoption benefits are communicating the seldom-used coverage and the taxability of awards. Unlike most other benefits, adoption benefits generally are taxable income to the employee. Administratively, most companies withhold taxes at the time the benefit is paid.

In all of the plans, no special allowance is made for adopting a handicapped child. However, children with preexisting medical problems are covered under the regular health plan after the final adoption. Similarly, the plans do not have specific provisions for unusual adoption situations, such as the adoption of an adult or family. The companies review these situations on a case-by-case basis.

The Future For Adoption Benefits

In discussing the future of adoption benefits, Hewitt concludes:

"Adoption benefits are by no means widespread. And because fewer babies are being given up for adoption, adoptions — particularly of newborns — have occurred less frequently in the past few years.

"Still, the number of companies who provide this benefit is increasing. Low usage makes the benefit relatively inexpensive and easy to administer. Employees appreciate its existence and employers benefit from the goodwill created.

"Because of the low incidence of adoption, employee pressure is not really a factor. More favorable tax treatment might provide a boost, but this issue does not seem to be overriding. Rather, the impetus for adoption benefits seems to be coming from companies themselves. Family demographics and social attitudes have undergone tremendous change in recent years. Perhaps adoption benefits are an idea whose time has come."

Major provisions of some of the plans studied by Hewitt are shown opposite. ■

ADOPTION BENEFIT CHARACTERISTICS

Benefit	Natural Child(ren)*	When Paid	Method of Funding	Usage	Company Reaction
$75 allowance	Covered	Final adoption	Medical plan	12 to 15 times per year	Started benefit when $75 was surgical allowance for pregnancy
Up to medical plan allowance for normal delivery for legal, court, and agency fees (based on latest 3-month average in area, $2,200 current figure)	Covered	Final adoption	General assets	2 to 4 times per year	Benefit cost is small for amount of positive PR generated, benefit is flexible — increases as area medical costs rise
Up to $500 for legal, court, and agency fees	Covered	Final adoption	General assets	10 times per year	Cost of benefit isn't considerable, employees have requested increase
80% of eligible charges for legal, court, agency, foreign adoption fees, pregnancy expenses for natural mother, and temporary foster care charges, maximum $1,000	Covered	As expenses are incurred	General assets	3 to 4 times per 1,000 employees per year	Some employees are unhappy with taxation, many are unaware of benefit, original $800 was increased in 1977 to $1,000
$1,000 allowance per adoption proceeding (e.g., one allowance for twins)	Not covered	Final adoption	General assets	4 to 5 times per year	Consistent with company production of birth control products, original $800 amount was increased in July 1979 to $1,000
Up to $300 for legal, court, agency, and natural mother's pregnancy expenses	Covered	Final adoption	General assets	1 to 5 times per year	Chose adoption benefit to equal 1/2 pregnancy allowance, nice benefit to talk about but not used much
Up to 3 months leave without pay plus $250 if child is younger than 6 months and his medical expenses at birth cannot be separated from the natural mother's medical expenses	Not covered	Final adoption	Medical plan	15 to 20 times per year	Little feedback because of small usage, company plans to review an increase in benefit
Up to $1,000 for legal, court, agency, and natural mother's pregnancy expenses	Not covered	When child is placed in home	General assets	5 times in 5 months of 1980 (only data available)	Since effective date and scope of benefit were clarified, it has been easy to administer

*Adoption of spouse's natural child(ren)

Senator METZENBAUM. Mr. Chairman, before I conclude, I would like to pay my respects to the efforts and the leadership of my distinguished colleague on my left, Senator Jepsen. Senator Baucus has legislation on this subject as well. And I certainly hope that all of us can work together to achieve the objective that I know we all seek.

I find myself privileged to work with such distinguished Senators.

Senator PACKWOOD. Senator Metzenbaum, thank you very much. All of the documents that you have offered will be placed in the record.

This committee has had a fair degree of success in getting the Congress to adopt a variety of tax-free fringe benefits—legal aid 5 years ago; day care just recently; educational benefits 2 years ago—and, indeed, if we are going to move away from Government financing, this is a very good alternative way to go, but there is no possibility of doing it if we are going to count it as income. By the time the employer has to figure if it is income—they have got to make the deductions, they have got to make the withholdings, and, finally, it gets to be a headache—for relatively slight amounts—and these are not overwhelming amounts that we are talking about—it gets to be a sufficient headache that it is a major deterrent to providing it at all.

Senator METZENBAUM. Well, I might say to you, Mr. Chairman, on a personal note, that I am particularly pleased that it so happens that you are the chairman of this subcommittee. I think it should be helpful because I know of your longstanding concern in these areas.

Senator PACKWOOD. I am very receptive.

Senator Jepsen.

STATEMENT OF HON. ROGER JEPSEN, A U.S. SENATOR FROM THE STATE OF IOWA

Senator JEPSEN. Thank you, Mr. Chairman. Mr. Chairman, I echo the sentiments of my distinguished colleague, Senator Metzenbaum, and will assure him that everything that we can do, my office and my staff, to cooperate and work together to reach and attain the end result that we are all interested in will be done. I thank him for his work. I thank you for your interest and your diligence. And I do thank my colleague, Senator Hatfield, for his support of my bill.

Please accept, Mr. Chairman, my sincere appreciation and thanks for permitting me to testify before your committee today on the matter of adoption. Today, there are literally millions of men and women, couples, who want to give love, care and affection to a young person, and there are untold millions who are wanting and needing that love, care and affection. Adoption is a necessary service not only to the family but also to the child and I will wholeheartedly support any effort to bring these two groups together in a responsible manner.

As the number of teenage pregnancies has increased, adoption as an alternative to abortion or adolescent parenthood has received little attention from our country's leaders, in either the political or the social sectors.

According to recent estimates, no more than 4 percent of unmarried teenagers who give birth are choosing an adoption plan for their baby. Some estimate that there has been as much as a 50-percent decline in the number of adoptions between 1970 and 1980. Increasing numbers of teenagers are choosing to keep their babies, even though most of them are not prepared for the task of parenting. Furthermore, in 1979, nearly twice as many teenagers chose to have an abortion rather than to carry their pregnancy to term. Today, these trends mean that there are fewer children available for adoption.

Meanwhile, the demand for adoptable babies is ever increasing. There are an estimated 10 million Americans who are incapable of bearing children or having children naturally. One out of every five couples, or 6 million couples of child-bearing age, are infertile. At present, if only one-quarter of these couples try to adopt a healthy infant, that means that 1½ million couples would be competing for just 22,000 infants.

Even though there are some couples eager to adopt, there are many "special needs" children waiting to be adopted. In October 1980, the U.S. Department of Health and Human Services released a study entitled, "Adoption Services in the States," wherein, it is estimated that about 502,000 children are currently in foster care and that nearly 215,000 of them might benefit from adoption services. A large percentage of these children are older, some are handicapped, and a significant number are members of racial minorities.

Mr. Chairman, as you are aware, I introduced an adoption amendment to the Economic Recovery Act of 1981. This amendment, which was passed unanimously by the U.S. Senate and signed into law by our President, will allow a deduction of up to $1,500 in adoption expenses if the adopted child was considered to be special needs. This includes children eligible for aid to families with dependent children, children eligible for supplemental security income, or children who are considered hard to place. For example, children who are older, handicapped, or a member of a racial minority.

This provision was a step in the right direction, and I believe it has brought about a renewed public awareness of the financial burdens being placed upon parents who wish to adopt. However, more needs to be done.

As you know, Mr. Chairman, the Family Protection Act of 1981, S. 1378, was introduced on June 17. Because of strong family ties and healthy family relationships that are generated by the adoption process, an adoption provision was highlighted in this act. This particular provision, section 207, was also introduced as an individual bill, Senate 1580.

My distinguished colleague, Senator Hatfield, testified in support of this bill earlier today.

Senate 1580 would provide an exemption of $1,000 for each child born to, or adopted by, the taxpayer during the taxable year. If the child were born handicapped, that exemption would increase to $3,000, and if the adopted child was considered hard to place the exemption would increase to $3,000.

As I mentioned earlier, under present law, the exemption for hard-to-place children is $1,500. Additionally, Senate 1580 would allow a choice of a deduction for both itemizers and nonitemizers or a nonrefundable credit for adoption expenses. The aggregate amount allowable would be $3,500 or $4,500 in the case of an international adoption.

Mr. Chairman, the emphasis of this bill would be to alleviate the burden being placed upon both the natural and the adoptive parents of hard-to-place and special-needs children. The National Study of Social Services to Children and Their Families found that there were 502,000 children in foster care in the United States in 1977; over 185,000, or 35 percent of these, were minority children; 28 percent were black children, 5 percent Hispanic children, and 4 percent children of other minority groups such as native American and Asian-Pacific. Yet, in 1976, minority children represented only 17 percent of the general population under 18 years of age. Minority children then were to be found in foster care more than twice as frequently as whites or Caucasian children.

If we look at the figures on handicapped children, the study found that nearly 10 percent of the children in foster care were physically handicapped. Of the 102,000 children free for adoption, 8 percent were physically handicapped.

Mr. Chairman, in these times of economic pressure and fiscal restraints, it is not popular to talk about further tax expenditures. Nevertheless, as social services and foster care programs are being cut back, adoption incentives are in the public interest. Certainly, legislation which provides tax deductions or even a tax credit to parents who wish to adopt will be more cost effective than Government programs that have been implemented to handle foster care. We can put no price tag on the love that a family can give to a needy child.

I believe that the tax proposals I have offered would help curb the dramatic impact in the initial cost of an adoption. To let the prohibitive initial costs of adoption deny a child an adoptive home and family is an injustice against the child and the prospective family, as well as our society.

In conclusion, Mr. Chairman, every child in America should have the opportunity to be surrounded by the love and the warmth that can be provided by a family. Likewise, every interested family should have the opportunity to share its family life with a child in need.

Mr. Chairman, I want to close my remarks today by thanking you for your concern, for the concern you and your committee have expressed regarding the issue of adoption. With your help, I believe that we are on our way to providing answers to this difficult question that will be mutually beneficial.

Because of the adoption amendment which was included in the Economic Recovery Act of 1981, I believe that this Congress has already shown its willingness to respond to the complexity of the problems facing the adoption process.

I appreciate, Mr. Chairman, your giving me the chance to speak to you and to testify before your committee, and I look forward to any comments or questions that you or anyone on your committee may have.

Thank you, Mr. Chairman.

Senator PACKWOOD. Senator Jepsen, thank you very much. And, again, congratulations on the success you had on the tax bill last year getting the amendment adopted on the hard-to-place children. It is a good step forward. I hope we can expand it.

Senator JEPSEN. Thank you, sir.

[The prepared statement of Senator Roger W. Jepsen, of Iowa follows:]

PREPARED STATEMENT OF SENATOR ROGER W. JEPSEN

Mr. Chairman, please accept my sincere appreciation and thanks for permitting me to testify before your committee today on the matter of adoption. Today there are literally millions of men and women, couples, who want to give love, care and affection to a young person, and there are untold millions who are wanting and needing that love, care and affection. Adoption is a necessary service not only to the family but also to the child and I will wholeheartedly support any effort to bring these two groups together in a responsible manner.

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According to recent estimates, no more than 4 percent of unmarried teenagers who give birth are choosing an adoption plan for their baby. Some estimate that there has been as much as a 50 percent decline in the number of adoptions between 1970 and 1980. Increasing numbers of teenagers are choosing to keep their babies, even though most of them are not prepared for the task of parenting. Furthermore, in 1979, nearly twice as many teenagers chose to have an abortion rather than to carry their pregnancy to term. Today, these trends mean that there are fewer children available for adoption.

Meanwhile, the demand for adoptable babies is ever increasing. There are an estimated 10 million Americans who are infertile. One out of every five couples, or 6 million couples of child-bearing age, are infertile. At present, if only one-quarter of these couples try to adopt a healthy infant, that means that 1.5 million couples would be competing for just 22,000 infants.

Even though there are some couples eager to adopt, there are many "special needs" children waiting to be adopted. In October of 1980, the U.S. Department of Health and Human Services released a study entitled, Adoption Services in the States, wherein it is estimated that about 502,000 children are currently in foster care and that nearly 215,000 of them might benefit from adoption services. A large percentage of these children are older, some are handicapped and a significant number are members of racial minorities.

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As you know, the Family Protection Act of 1981, S. 1378 was introduced on June 17. Because of the strong family ties and healthy family relationships that are generated by the adoption process, an adoption provision was highlighted in this act. This particular provision (Sec. 207) was also introduced as an individual bill—S. 1580.

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Congressional Research Service
The Library of Congress

Washington, D.C. 20540

October 9, 1981

TO : Honorable Roger Jepsen
Attention: Virginia Bessey

FROM : Cheryl Savage Newton
Analyst in Public Finance
Economics Division

SUBJECT : Comparison of Adoption Provisions of S. 1580 and the Recently Enacted Economic Recovery Tax Act of 1981

This memorandum is written in response to your request for a comparison of S. 1580 and the adoption provisions of the recently enacted Economic Recovery Tax Act of 1981 (ERTA), Public Law 97-34.

ERTA created a new itemized deduction for adoption expenses which is available for tax year 1981 and later years. Up to $1,500 may be deducted for the adoption exenses of a "child with special needs." ERTA defines a child with special needs as a child with respect to whom adoption assistance payments are made under section 473 of the Social Security Act.

According to section 473, a child with respect to whom such adoption assistance payments can be made must be eligible for Aid to Families with Dependent Children or Supplemental Security Income and must be a "child with special needs." It is very important to note that "child with special needs" is defined two different ways in ERTA and in the Social Security Act. In section 473 of the Social Security Act, a child with special needs is one who would be unadoptable without the adoption assistance program, due to such factors as the child's ethnic background, age, or membership in a minority or sibling group, or the [redacted] The children who have special needs by section 473's definition form a larger group than the children who have special needs by ERTA's definition. By ERTA's definition, children with special needs must meet the definition of section 473 of the Social Security Act and must also be eligible for Aid to Families with Dependent Children or Supplemental Security Income.

S. 1580 is considerably more generous in its treatment of adoption expenses than is ERTA. S. 1580 provides extra exemptions for both births and adoptions and also allows the taxpayer a credit for the expenses of an adoption.

The basic exemption allowed is $1,000 for each child born to, or adopted by, the taxpayer during the taxable year. This is in addition to the normal $1,000 exemption already allowed for a dependent child. If a woman (only a married woman, as is explained below) were to give her baby up for adoption, she could conceivably claim the $1,000 exemption for bearing the child at the same time that the adoptive parents claim another two $1,000 exemptions on the child's behalf: one exemption would be the special exemption provided by S. 1580; the other would be the normal dependent's exemption.

If a child born to the taxpayer is handicapped, the special exemption is $3,000 instead of $1,000. If an adopted child is a member of a minority race or ethnic group, age 6 or older, or handicapped, the special exemption is $3,000 instead of $1,000.

Unmarried people and married people filing separately are not permitted to claim the special exemption.

If the extra exemption is larger than the taxpayer's tax liability, then the unused exemption can be carried over to the next year.

S. 1580 also allows the taxpayer a deduction (available to both itemizers and nonitemizers) or nonrefundable credit for a portion of adoption expenses.

As will be explained below, the deduction option provided is superfluous. It would be irrational for the taxpayer to ever choose the deduction over the credit.

The deduction or credit can be claimed for up to $3,500 of any child's adoption expenses. In the case of an international adoption, the maximum is $4,500. The first $500 of adoption expenses is disregarded; no credit or deduction is allowed for that initial amount.

The reason that the deduction option of this bill will never be used is that a deduction reduces the taxpayer's tax bill by only a fraction of the deducted amount, while a credit reduces the taxpayer's bill dollar-for-dollar, by the full amount of the credit (up to the amount of the tax bill, since this credit is nonrefundable). A deduction is subtracted from income, while a credit is subtracted directly from the tax bill. For example, a $100 deduction reduces the taxpayer's bill by $30 if he is in the 30 percent tax bracket, $40 if he is in the 40 percent tax bracket, and $50 if he is in the 50 percent tax bracket. A $100 credit, however, reduces the taxpayer's bill by $100 (provided he has a tax liability of at least $100), no matter what tax bracket he is in. And, as long as one compares a deduction of a particular size with a credit of the same size, the credit will be preferred by taxpayers in all tax brackets. Only if the credit is smaller than the deduction will some taxpayers, depending on their tax brackets, prefer the deduction. Compare a $100 deduction to a $40 credit. A taxpayer in the 30 percent bracket will prefer the credit because the credit reduces his tax bill by $40, $10 more than the deduction. A taxpayer in the 40 percent bracket will be indifferent between the credit and the deduction because they both reduce his tax bill by $40. Finally, the taxpayer in the 50 percent bracket will prefer the deduction because the deduction reduces his tax bill by $50, $10 more than the credit.

The following outlines of S. 1580 and the adoption provision of ERTA should facilitate easy comparison of the two bills. The attached report by Louis Alan Talley compares tax credits and deductions.

Outline of S. 1580

1. Provides an exemption of $1,000 for each child born to, or adopted by, the taxpayer during the taxable year.

   A. If a child born to the taxpayer is handicapped, the exemption is $3,000.

   B. If an adopted child is:
   i) a member of a minority race or ethnic group;
   or
   ii) 6 or older;
   or
   iii) handicapped;
   the exemption is $3,000.

   C. This exemption cannot go to unmarried people or to married people filing separately.

   D. Left-over exemption can be carried over to the next year.

2. Choice of deduction (for both itemizers and nonitemizers) or nonrefundable credit for adoption expenses.

   A. First $500 of expenses disregarded.

   B. Aggregate amount allowable is $3,500 ($4,500 in the case of an international adoption).

   C. Note that the taxpayer will never rationally choose the deduction in preference to the credit.

Outline of Adoption Provision of Economic Recovery Tax Act of 1981

1. Allows up to $1,500 deduction for adoption expenses of "child with special needs." For itemizers only.

   A. The term "child with special needs" means a child with respect to whom adoption assistance payments are made under section 473 of the Social Security Act. According to section 473, such a child must:

(i) be eligible for Aid to Families with Dependent Children;
or
(ii) be eligible for Supplemental Security Income;
and
(iii) be a child with "special needs." According to section 473, a child has special needs if there exists with respect to the child a specific factor or condition (such as his ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions or physical, mental, or emotional handicaps) because of which it is reasonable to conclude that such child cannot be placed with adoptive parents without providing adoption assistance.

Senator PACKWOOD. Russell, any questions?

Senator LONG. No.

Senator PACKWOOD. Thank you very much. I see Senator Sasser in the audience. Good morning.

STATEMENT OF HON. JIM SASSER, A U.S. SENATOR FROM THE STATE OF TENNESSEE

Senator SASSER. Good morning, Mr. Chairman, Senator Long. Mr. Chairman, it is a pleasure for me to be here this morning. And I have some good news and some bad news for this subcommittee. The bad news is that I have a long, detailed statement on this particular topic that I am going to testify on this morning, but the good news is that I will summarize it. And I ask that my full statement be included in the record as if read.

Senator PACKWOOD. I might ask all the other witnesses who testify that they hear what he said and would follow his example. I have just started to read Mr. Chapoton's statement, especially, and hope he does the same thing.

[The prepared statement of Senator Jim Sasser, of Tennessee follows:]

PREPARED STATEMENT OF JIM SASSER

Mr. Chairman, it's a pleasure to be here this morning, and I want to commend you on the leadership role you have taken in the mortgage bond program. I know that your constitutents in Oregon have had many of the same problems that the people in Tennessee have had, that housing officials all across the country have had, in trying to make this program work.

This morning's hearings may mark the beginning of the end of those problems. I'm glad to have the opportunity to be here, on behalf of myself and Senator Baker, to make the case for passage of S. 1348. Also here this morning will be two gentlemen from Tennessee, representing State and local governments, who have worked as diligently as any two people in the country to make the mortgage bond program work for their jurisdictions. Chairman Grady Haynes of the Tennessee Housing Development Agency and Mayor Bill Morris of Shelby County will be participating in the State and local panels later this morning, and I know each of them has a great deal to contribute in front-line experience with the problems we are gathered here to solve.

The problems with the mortgage bond programs must be solved. I know all of us here this morning are aware of the deepening crisis in the housing industry, and I will not take the subcommittee's time in recounting all the statistics. Our focus here is the Mortgage Subsidy Bond Tax Act of 1980 and the need to make corrections in it. I would make note, however, of the fact that existing-home sales dropped to their lowest level in 6 years in August. That decline occurred after 7 consecutive months of what we had hoped was a bottoming-out of the housing recession. Since 1978, resale activity has dropped 35 percent in the Northeast, 44 percent in the South, 44 percent in the North Central region and 49 percent in the West. That is resale activity, and those are devastating numbers. In new construction, starts are below half of estimated demand and unemployment in the construction is at 16.7 percent and climbing.

In other words, Mr. Chairman, we may be in the business here this morning of formulating a safety net for the American housing industry. I don't think any of us have any illusions that the mortgage bond program is a cure-all for the critical problems facing young first-time buyers and all the housing-related industries that depend on construction and sales. But in the face of continued high interest rates, there has to be a mechanism available for maintaining at least a minimum level of activity in these sectors of our economy. If no such mechanism is available, the price we will pay in the future will be staggering.

The legislation I have introduced with Senator Baker to make the mortgage bond program workable again, S. 1348, now has 35 cosponsors. These 35 Senators represent every region in the country and a pretty extraordinary range of economic philosophies. The cosponsors in the House are just as broadly representative. I think the geographical and political diversity of the supporters of this bill is an indication of the size of the problem it seeks to address. S. 1348 has also been endorsed by the key public interest and industry groups affected by the mortgage bond program: the National Association of Homebuilders, the Council of State Housing Agencies, the National Conference of State Legislatures, the National League of Cities, and the National Lumber and Building Material Dealers Association.

Fundamentally, S. 1348 makes it possible for issuers to offer sound, productive, tax-exempt bonds to investors, and to use those dollars in a cost-effecient manner to make affordable mortgage money available to more moderate-income, first-time homebuyers. It does that by assuring an adequate yield for the issuer, an unqualified tax opinion for investors, and reasonable definitions of eligible buyers and targeted area . . . without expanding the important limits or allocations imposed by the 1980 act. As you are probably aware, the Joint Tax Committee has assessed S. 1348 as having negligible budget impact.

Before I make a few brief comments about the specific provisions of S. 1348, let me note once again that if we pass the legislation and the mortgage bond market goes to work once again, we could finance the construction or resale of some 200,000 to 285,000 housing units nationwide, up to 4,435 in Tennessee alone.

And I would submit for the record data that indicate the numbers of housing units by State that passage of S. 1348 could help finance.

Now, let me touch on a few key provisions of S. 1348. This bill provides for a yield—or arbitrage limitation as we have been calling it—of 1.5 percent. It was at 1.5 percent before passage of the Mortgage Subsidy Bond Tax Act and in our opinion it should be restored to that level. That was, and is, the standard level prescribed by the Internal Revenue Service for all other similar types of issues . . . even without the requirement that certain costs be covered within that figure. That was, and is, the minimum level at which many States and localities can afford to participate in the program. I should point out that S. 1348 does not provide for an absolute return to the yield provisions in effect prior to the 1980 act: our bill continues the requirement that key program costs be covered within the 15 percent. In that way, cost-effectiveness, as well as affordability, is insured.

Furthermore, the issuer is permitted under my bill to maintain a reserve fund, and is not required to divert holdings at a loss to meet arbitrary requirements. The sound financial practices provided in S. 1348 will assure the solvency of each program. To force a State or local authority to operate to its own disadvantage by selling at a loss is an unwarranted Federal intrusion.

The "good faith covenant," as opposed to the 95-percent compliance test, is another key element of S. 1348. Under the 1980 act, no more than 5 percent of any issue may be involved in noncomplying loans; otherwise, the tax-exempt status will be withdrawn. That's not 5 percent at any given time or 5 percent in uncorrected errors. That's a cumulative 5 percent, including even those loans which have been brought into compliance. And when the tax exemption is withdrawn the issue becomes taxable retroactively, not just until the date on which the 5-percent limit was exceeded but to the date of issue. Normally, the good faith covenant of the issuer is a key aspect of this process; reliance on that covenant is standard practice in similar bond issues, even with a 90-percent compliance test as in industrial development bond issues. I see no reasons for making an exception in this case, especially when the covenant is accompanied by a requirement that all noncomplying loans be corrected within a reasonable period. I would further point out the responsibility for monitoring the program rests properly with the issuing agency under S. 1348, not with the bondholders as in current law. In addition, the maintenance of the threat of cancellation of tax-exempt status, whatever other provisions are added, will maintain the certainty of a qualified opinion from bond counsel. We need to insure that the issues are properly policed and brought into compliance, but also to insure the status of the bonds to be able to get them sold.

Moreover, there should be no exception made in the matter of the registration requirement. Again, standard practice in issues of this type does not require registration of the issue. Mortgage bonds, therefore, suffer an inequitable disadvantage in the market if the requirement is continued. If the committee decides to require registration on all issues, then the discriminatory aspect of this provision would be removed. In the absence of such action, the requirement should be removed, as S. 1348 provides.

S. 1348 also clarifies the definition of "first-time homebuyers." Those who have owned substandard housing or who have lost their homes due to governmental action or natural disaster would not be disqualified by such previous ownership. In addition, the definition of "targeted area" is refined to include areas designated as impacted by increased production of coal, uranium, oil, gas or other energy related materials which meet the criteria of the Powerplant and Industrial Fuel Use Act of 1978. This section is of key importance to those States struggling to cope with the rapid influx of workers into energy production areas where no housing—or infrastructure—has existed.

On behalf of myself and Senator Baker, and the rest of our cosponsors, I want to thank you for this opportunity to appear before the subcommittee. I have faith that you and your colleagues on the committee will devise an equitable, workable solution to getting the mortgage bond program moving again. And I would respectfully suggest that the provisions of S. 1348 provide an excellent framework for that task.

Thank you, Mr. Chairman.

State (ceiling)	New		Existing	
	AAPP[1]	Units[2]	AAPP[1]	Units[2]
Alabama ($200,000,000)	$64,700	3,091	$56,100	3,565
Alaska ($200,000,000)	107,700	1,987	82,900	2,411
Arizona ($203,500,000):				
High	89,100	2,284	79,800	2,550
Low	76,300	2,667	61,400	3,314
Arkansas ($200,000,000):				
High	64,400	3,106	61,400	3,257
Low	62,100	3,221	58,500	3,419
California ($2,217,600,000):				
High	132,800	16,699	144,800	15,400
Low	66,700	33,247	57,800	38,367
Colorado ($308,800,000):				
High	80,000	3,860	70,200	4,399
Low	78,500	3,394	54,900	5,625
Connecticut ($200,000,000):				
High	142,000	1,408	142,600	1,403
Low	73,700	2,714	59,800	3,344
Delaware ($200,000,000)	75,200	2,660	58,100	3,442
District of Columbia ($200,000,000)	100,100	1,998	93,200	2,146
Florida ($614,900,000):				
High	80,300	7,658	70,300	8,747
Low	55,500	11,079	38,400	16,013
Georgia ($201,500,000):				
High	88,100	2,287	67,000	3,007
Low	59,300	3,398	46,900	4,296
Hawaii ($200,000,000):				
High	152,200	1,314	112,800	1,773
Low	117,000	1,709	109,900	1,820
Idaho ($200,000,000)	78,500	2,548	67,100	2,981
Illinois ($632,200,000):				
High	82,100	7,700	71,300	8,867
Low	73,400	8,613	43,400	14,567
Indiana ($221,200,000):				
High	85,600	2,584	49,900	4,433
Low	66,500	3,915	46,100	4,798
Iowa ($200,000,000)	70,900	2,821	51,600	4,287

State (ceiling)	New		Existing	
	AAPP [1]	Units [2]	AAPP [1]	Units [2]
Kansas ($200,000,000):				
High	71,900	2,821	51,600	4,287
Low	54,400	3,676	41,600	4,808
Kentucky ($200,000,000):				
High	72,100	2,774	50,200	3,984
Low	58,400	3,425	44,300	4,515
Louisiana ($200,000,000):				
High	93,000	2,151	74,800	2,674
Low	76,900	2,601	56,200	3,559
Maine ($200,000,000)	73,500	2,721	58,200	3,436
Maryland ($240,400,000):				
High	84,500	2,845	58,700	4,095
Low	55,100	4,363	56,500	4,225
Michigan ($362,700,000):				
High	99,300	3,653	56,200	6,454
Low	77,500	4,680	45,000	8,060
Minnesota ($239,800,000):				
High	93,200	2,573	68,800	3,485
Low	70,900	3,382	56,900	4,214
Mississippi ($200,000,000)	65,700	3,044	47,100	4,246
Missouri ($220,900,000):				
High	82,800	2,668	51,400	4,298
Low	58,800	3,757	47,100	4,690
Montana ($200,000,000)	79,300	2,522	62,300	3,210
Nebraska ($200,000,000):				
High	62,500	3,200	51,300	3,899
Low	50,700	3,945	40,000	5,000
Nevada ($200,000,000)	98,000	2,041	94,500	2,116
New Hampshire ($200,000,000)	62,300	3,210	54,400	3,676
New Jersey ($319,700,000):				
High	107,900	2,962	87,600	3,650
Low	77,500	4,125	71,000	4,503
New Mexico ($200,000,000)	64,900	3,082	46,400	4,310
New York ($412,900,000):				
High	93,600	4,411	79,400	5,200
Low	65,500	6,304	41,800	9,898
North Carolina ($200,000,000):				
High	88,800	2,252	59,300	3,373
Low	44,800	4,464	43,200	4,630
North Dakota ($200,000,000)	79,300	2,522	62,300	3,210
Ohio ($540,400,000):				
High	86,200	6,269	59,600	9,067
Low	62,600	8,663	44,400	12,171
Oklahoma ($200,000,000):				
High	95,600	2,092	66,600	3,003
Low	67,600	2,959	46,200	4,329
Oregon ($200,000,000):				
High	76,500	2,614	61,800	3,236
Low	65,600	3,049	52,400	3,817
Pennsylvania ($430,400,000):				
High	77,100	5,582	57,800	7,446
Low	46,800	9,917	33,300	12,925
Rhode Island ($200,000,000):				
High	73,500	2,721	58,200	3,436
Low	71,800	2,786	51,400	3,891
South Carolina ($200,000,000):				
High	80,500	2,484	64,500	3,101
Low	53,000	3,794	49,600	4,032
South Dakota ($200,000,000)	79,300	2,522	62,300	3,210
Tennessee ($200,000,000):				
High	82,000	2,439	62,900	3,180
Low	47,800	4,184	45,100	4,435
Texas ($775,400,000):				
High	111,400	6,961	86,200	8,995
Low	64,200	12,078	50,500	15,354

State (ceiling)	New		Existing	
	AAPP[1]	Units[2]	AAPP[1]	Units[2]
Utah ($200,000,000):				
High	91,700	2,181	54,900	3,643
Low	76,600	2,611	54,300	3,683
Vermont ($200,000,000)	58,400	3,425	47,900	4,175
Virginia ($309,000,000):				
High	85,500	3,614	60,700	5,091
Low	67,500	4,578	49,800	6,205
Washington ($239,900,000):				
High	76,400	3,140	76,500	3,136
Low	72,600	3,304	57,400	4,179
West Virginia ($200,000,000)	56,000	3,571	50,900	3,929
Wisconsin ($200,000,000)	70,300	2,845	55,200	3,623
Wyoming ($200,000,000)	79,300	2,522	62,300	3,210

[1] AAPP = Average area purchasing price.

[2] Units = Number of units that can be financed at indicated average area purchasing price under State mortgage bond ceiling limitation.

Senator PACKWOOD. Go ahead, Jim.

Senator SASSER. Thank you, Mr. Chairman. First, I want to commend the chairman for the leadership role that he has taken in the mortgage bond program. I know that your constituents in Oregon have many of the same problems that my constituents have in Tennessee, and indeed that housing officials all across the country have had in trying to make this mortgage bond program work.

Now, I think this morning's hearings may mark the beginning of the end of the problems that we face. I am glad to have the opportunity to be here on behalf of myself and also on behalf of my able and distinguished senior colleague, Senator Baker, to make the case for passage of S. 1348. Also this morning there will be testifying and appearing on a panel a fellow Tennesseean, Chairman Grady Haynes, of the Tennessee Housing Development Agency, who has done more than anyone I know in the effort to solve some of the problems that we have been confronted with in the mortgage bond area.

My statement and my thesis are simple, that the mortgage bond program simply must be put back to work again. I know all of us this morning are only too aware of the deepening crisis in the housing industry. And I am not going to take this subcommittee's time by recounting in detail the problems of that troubled industry, or going into a lot of statistics. Our focus here is the Mortgage Subsidy Bond Act of 1980 and the need to make corrections in that statute. I will note, however, that existing home sales dropped to their lowest level in 6 years in August of this year. In my reading of the material which was supplied to me by the National Association of Realtors and in my conversations with realtors throughout my native state, I found that the statistics on home sale declines really are truly devastating.

Since November 1978, resales of existing homes declined by 44 percent, almost cut in half, and some 2½ million housing units with a book value of $175 billion have gone unsold. And, frankly, the end is nowhere in sight.

In new construction, housing starts are about half of the estimated national demand. Unemployment in the construction industry is at 16.7 percent, well over twice the national average in unemployment for all occupations. At the rate it is climbing, it will soon be three times the national average.

And I am concerned, as I know this subcommittee is concerned, about the pent-up demand for housing that is being developed. I suspect that when interest rates do go down at sometime hopefully in the not too distant future, we are going to see terrific inflation in the housing market, as those who have been denied housing over a number of years because of the interest rate problem rush back in to try to take advantage of housing that may be available at that time.

Fundamentally, S. 1348 makes it possible for issuers to offer sound, productive, tax-exempt bonds to investors, and to use those dollars in a cost efficient manner to make affordable mortgage money available to more modest income, first-time, home buyers. It does that by providing an adequate yield for the issuer, an unqualified tax opinion for investors, and a reasonable definition of eligible buyers in targeted areas—all without expanding the important limits or allocations imposed by the 1980 act. It returns significant authority for the program over to State and local issuers. A more detailed explanation of this is found in my formal statement.

Let me note at this point that if we pass the legislation and the mortgage bond market goes to work once again, we could help finance construction or resale of some 200,000 to 285,000 housing units nationwide. And I might say, parenthetically, Mr. Chairman, and perhaps more importantly to me and maybe even more importantly to Senator Baker, it will finance 4,400 in our State of Tennessee.

S. 1348 provides the basis for a workable mortgage bond program. So on behalf of myself, Senator Baker, and the rest of our cosponsors, I want to thank the subcommittee and the chairman for the opportunity to appear. I have faith that you and your colleagues on the Finance Committee will devise an equitable and working solution to the problems in the mortgage bond program.

I would respectfully suggest this morning that S. 1348 provides an excellent framework for that task. Thank you for letting me appear.

Senator PACKWOOD. Senator, I have a dual interest in your bill and others on this subject. Oregon has a mortgage bond program. But in addition, probably in your 4,400 houses and every other State is a fair amount of wood that comes from Oregon.

Senator SASSER. Indeed.

Senator PACKWOOD. So from a dual standpoint, I am very interested in these bills.

Senator Long?

Senator LONG. Let me just say that something has to be done if the economy is going to move. If it does not move, it is indicative that the President's recovery program will never be achieved. I believe that if the Treasury has not done it, it ought to start making their studies in this area as well as in other areas to see whether we really have been as effective as we think we were by passing the big tax cut. Someone told me just yesterday that, to a lot of companies, the incentive to expand is no more than it was back in 1978 and 1979 because the high interest rates have offset the additional incentive that was available from the tax cut. There is no doubt about it as far as this industry is concerned, if you take everything into consideration.

What is happening now is just the opposite of what I would expect anyone would want. What is wrong with the economy and wrong with Government financing and all the rest? One thing that would tend to correct all that would be economic growth. And we are not getting it. This industry for which you speak I think is a prime example. The demand is there; people want the homes. But here is a set of circumstances that mean they cannot buy them. We ought to remove those obstacles. Without that, that, plus the same type of thing in industry, I don't see how the President's objective will be achieved.

Senator **Sasser**. I might say, Mr. Chairman, I certainly agree with the remarks made there by my distinguished colleague from Louisiana. I don't think we are going to get an economic recovery program really underway until we can get a recovery program going in some of the basic fundamental industries in this country. And certainly home building and providing homes for the American people is one of the fundamental industries.

So, again, just let me say that I welcome the interest of the chairman and this subcommittee in this legislation, and I think it may go a long way to try and revitalize real estate industry in this country, and home building, and, hopefully, a lot more of Oregon wood will be consumed in the construction of these homes. Thank you.

Senator **Packwood**. Thank you very much, Senator Sasser.

Have any other congressional witnesses come in? I haven't seen any.

[No response.]

Senator **Packwood**. Then let's move to Secretary Chapoton. Good morning.

Let me interrupt you for just a moment. I am going to put the statements of Senators Dole and Wallop in the record just prior to your statement.

[The prepared statements of Senators Dole and Wallop and Assistant Secretary Chapoton follow:]

Prepared Statement of Senator Dole

Mr. Chairman, today we have an opportunity to hear the views of the members of the public on tax bills concerning the tax treatment of adoption expenses and tax bills which would amend the Mortgage Subsidy Bond Tax Act of 1980.

ADOPTION EXPENSES

The Economic Recovery Tax Act of 1981, P.L. 97-34, allows taxpayers who itemize deductions to deduct, up to a limit of $1500, reasonable and necessary adoption expenses paid or incurred with the adoption of a child who has been found by the state to be eligible for adoption assistance because of a specific factor or condition which leads the state to believe that the child cannot be placed without adoption assistance.

Two of the three adoption expense bills, S. 608 and S. 1479, expand the current adoption expense deduction by extending it to all individual taxpayers, whether or not they itemize deductions, and by allowing the deduction of an unlimited amount of adoption expenses for adoption of any child. In addition, S. 1479 also would encourage the creation of employer-funded adoption expense plans.

The third adoption expense bill, S. 1580, would provide married taxpayers who give birth to or adopt a child with an additional personal exemption of $1,000 and if the child is handicapped or meets certain criteria, an additional personal exemption of $3,000. S. 1580 would also provide individuals an election take a deduction or to take a tax credit up to $3,500 ($4,500 in the case of an international adoption) for adoption expenses in excess of $500.

These adoption expense bills present this subcommittee with important tax policy decisions which will impact American families and we look forward to hearing the views of the public on this important topic.

MORTGAGE SUBSIDY BONDS

The second topic of today's hearing is the liberalization of certain rules we established in the Mortgage Subsidy Bond Tax Act of 1980. Apparently what we thought was laid to rest a year ago was not—critics claim we drew the statute too tightly and killed the mortgage subsidy bond program. I tend to think that high interest rates, competition from All-Savers certificates, and a six-month period with no regulations are more to blame for the apparent decline of the program, but even so, there may be room for reasonable men to differ on some of the points at issue here.

For instance, there may be room to compromise on the issue of enforcing the "mortgagor requirements"—the first-time homebuyer and principal residence rules. Some effective enforcement mechanism, however, other than mere "good faith," or a promise to ferret out fraud, and mechanism that is implemented by the issuer, is imperative.

I hope we'll hear some suggestions today. Further, the provisions of the statute that could force the sale of reserves at a loss ought to be studied. These problems might even be addressed by regulation.

I am not so sympathetic, however, with other changes proposed by these bills. I do not, by my lack of sympathy, wish to suggest that I am opposed to providing housing for the middle-class or the poor. The arbitrage limit issue, however, has little to do with housing for the poor and a lot to do with substantial fees for well-to-do bond lawyers and underwriters. These very healthy sums—$100 an hour and up and straight out of the pockets of the lower and middle-class homeowners who are the intended beneficiaries of this program—may have become a way of life in the tax-exempt bond industry, but this Senator hopes the members of this subcommittee will not feel constrained to accept this fact of life as unalterable. It will take a much greater showing than a mere assertion of fact to convince ~~me that $200,000 is not~~ a reasonable sum to pay the transaction costs for a $20 million bond issue.

I look forward to being informed by today's witnesses.

PREPARED STATEMENT OF SENATOR MALCOLM WALLOP

I would like to take this opportunity to make just a few comments regarding legislation on the mortgage revenue bond program this subcommittee is considering this morning.

Because of our country's ravenous appetite for energy it is estimated that in this decade alone many communities in my home State of Wyoming will feel the explosive effects of a 46 percent growth in population. To handle this type of dramatic growth, new housing will have to be built to accommodate approximately 9,000 families a year. Without any adjustments for inflation, it will take approximately 500 million dollars a year to fund that needed housing. It is for this reason that Wyoming will look to the Wyoming Community Development Authority and mortgage revenue bonds to provide some of the capital necessary to finance that housing.

Several aspects of the Mortgage Subsidy Bond Tax Act of 1980 have worked to hamstring the ability of agencies across the country, like the Wyoming Community Development Authority, to effectively provide significant amounts of mortgage capital. Prior to the passage of the 1980 Act, 13.9 billion dollars in mortgage revenue bonds were issued. Since passage of this act, only one bond issue has been delivered—and that issue was of limited success. This fact alone is certainly a clear indication that changes are needed in the program.

A principal reason for the disappointing results since the passage of the 1980 Act has been that the strict level of compliance with the three conditions which must be met in order for an issue to retain its tax-free status is so inflexible that investors have been reluctant to invest in the bonds. When this factor is coupled with the crippling expense of maintaining the necessary and very detailed records proving compliance, the requirement becomes an administrative nightmare and totally impractical to boot. While I do not believe the conditions imposed by present law are unreasonable, I do believe that the flexibility of a "good faith" compliance test not only furnishes a reasonable assurance that these conditions will be met, but provides a sound mechanism to judge the effectiveness of the program.

Under the 1980 Act, proceeds from mortgage revenue bonds cannot be used to finance homes with a purchase price in excess of 90 percent of the average purchase price in the area. However, if the area is a targeted area, then a residence which is 110 percent of the average purchase price in the area can qualify under the program. The bill introduced by my colleague, Senator Sasser, provides that "energy impacted areas" would be considered targeted areas under the Act. One almost has to experience the type of spontaneous growth which takes place, like that which has occurred in Gillette, Evanston and Rock Springs, Wyoming, when a major energy development project is undertaken. The influx of thousands of workers and their families is met with limited housing at spiralling prices. These are not rich families, but people from all over this country as well as Wyoming searching for greater opportunities. They need roofs over their heads at rates they can afford. At current interest rates most of these people cannot afford to buy houses, and home builders cannot afford to build them. Targeting "energy impact" areas will serve to ease some of these problems.

Both of the bills being heard here today provide for modest increases in the arbitrage percentage. The experience of the different state agencies charged with implementing the mortgage revenue bond program has revealed that 1 percent figure presently in place has not proved sufficient to cover the expenses relating to the issuing and administering of the revenue bonds. An increase in the arbitrage percentage by a quarter to a half of a percentage point can make a significant difference in the effectiveness of the overall program.

In conclusion, I would like to commend my collleagues, Senator Sasser and Senator Durenberger, on their efforts to correct the existing deficiencies in the present mortgage revenue bond program. I feel that this mechanism will greatly assist not only homebuyers, but homebuilders who are especially hard hit by the current level of interest rates.

For Release Upon Delivery
Expected at 9:30 EDT
October 16, 1981

STATEMENT OF THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY FOR TAX POLICY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE COMMITTEE ON FINANCE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before the Subcommittee to present the views of the Treasury Department on this group of six miscellaneous tax bills.

Three of the bills, S. 608, S. 1479 and S. 1580, provide various deductions, exemptions, exclusions and credits with respect to adoption expenses. Treasury opposes S. 608, S. 1479 and S. 1580.

The other three bills, S. 425, S. 1348 and S. 1656, would amend certain of the provisions of the Mortgage Subsidy Bond Tax Act of 1980. Treasury is opposed to S. 425. In general, Treasury is opposed to the provisions of S. 1348 and S. 1656 which would make changes in the arbitrage limitations for mortgage subsidy bonds and which would repeal the requirement that such bonds be registered. We also oppose any effort to extend the mortgage revenue bond provisions beyond their current cut off date of December 31, 1983.

S. 608, S. 1479, and S. 1580

Deductions, exemptions, exclusions and credits for adoption expenses

S. 608, S. 1479 and S. 1580 would provide various deductions, exemptions, exclusions and credits with respect to adoption expenses.1/

S. 608

S. 608 would provide a deduction for the amount of adoption expenses paid or incurred by the taxpayer during the taxable year. The deduction would be available regardless of whether the taxpayer itemized his or her expenses (i.e., it would be an "above-the-line" deduction). In general, adoption expenses would be deductible if they were reasonable and necessary, directly related to the legal adoption of a child arranged by a public welfare department (or similar agency) or a government-authorized not-for-profit voluntary adoption agency, and not incurred in violation of Federal or state law. All such expenses would be deductible without a dollar limit and without regard to the taxpayer's income.

S. 1580

S. 1580 would provide three different incentives for the adoption of a child.

First, S. 1580 would provide an additional one-time $1,000 personal exemption for each child born to, or adopted by, a married taxpayer during the taxable year. The exemption would be $3,000 rather than $1,000 if a handicapped child were born to the taxpayer or if a child were adopted

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1/ These would apparently all be in addition to the deduction for certain adoption expenses provided by section 222 as added by the Economic Recovery Tax Act of 1981. Under this provision, in general, up to $1,500 (per adoption) of reasonable and necessary legal adoption expenses directly related to the legal adoption of a child with special needs may be deducted. A child with special needs is defined as a child with respect to whom adoption assistance payments are made under section 473 of the Social Security Act (generally, a child who the State determines should not or cannot be returned to the home of his natural parents and who, because of certain enumerated factors, could not reasonably be expected to be placed with adoptive parents without assistance payments).

(i) who was a member of a minority race or ethnic group, (ii) who was six years old at the beginning of the taxable year, or (iii) who was handicapped. The exemptions would be available without regard to actual expenses incurred and without regard to the taxpayer's income.

Second, S. 1580 would provide a dollar-for-dollar credit against tax for adoption expenses paid or incurred by the taxpayer during the taxable year. "Adoption expenses" are defined, generally, as reasonable and necessary expenses directly related to the legal adoption of a child by the taxpayer and not incurred in violation of Federal or state law. The credit would not be available for the first $500 of adoption expenses with respect to the adoption and would be limited to $3,500 per adoption ($4,500 for an "international adoption"). (An international adoption is defined as an adoption occurring under the laws of a foreign country or involving a child who was a citizen of a foreign country and who was brought to the United States for purposes of adoption or came to the United States under circumstances such that the child's placement for adoption was reasonably foreseeable). The credit would be available without regard to the taxpayer's income.

Third, S. 1580 would provide an "above-the-line" deduction for adoption expenses. The amounts eligible for the deduction would be similar to those for which the credit would be available and the deduction would only be available in lieu of the credit. It is difficult to envision a situation where the taxpayer would prefer the deduction to the credit.

S. 1479

S. 1479 would provide an "above-the-line" deduction for the amount of adoption expenses paid or incurred by the taxpayer during the taxable year and not compensated by insurance or otherwise. The deduction would be similar to the one provided by S. 608. The expenses would be deductible without dollar limit and without regard to the taxpayer's income.

In addition, S. 1479 would provide favorable tax treatment for an "adoption expense plan" established by an employer. If the employer set up an "adoption expense plan" to reimburse employee adoption expenses, then neither amounts contributed by the employer on behalf of the employee to the plan nor amounts paid by the plan to the employee would be includible in the employee's gross income. In addition, contributions by employers to such plans would be deductible as ordinary and necessary business expenses. Adoption expense plans would be subject to restrictions similar to those imposed on self-insured medical reimbursement plans (i.e., relating to benefits paid to highly compensated employees).

Treasury Position

Treasury opposes each of S. 608, S. 1580 and S. 1479. We do not think these measures are an appropriate way to provide Federal aid for adoption:

1. Unlimited deduction for adoption expenses (S. 608 and S. 1479). Both S. 608 and S. 1479 provide adoption expense deductions that are unlimited in dollar amount. We believe that, by analogy to a conventional Federal aid program, there should be some dollar limit on the expenses eligible for a deduction.

Moreover, the fact that these bills provide for a deduction, rather than a credit, means that greater benefits will go to taxpayers with higher incomes. It would be more appropriate to provide a credit (equal to some percentage of adoption expenses) because it would provide the same amount of aid to taxpayers with differing incomes. Indeed, it would be preferable to have a credit which decreases as the income of the taxpayer increases because the lower the taxpayer's income, the greater the need for adoption aid. 2/

Finally, the adoption expense deductions provided by S. 608 and S. 1479 are in no way targeted to provide aid or incentives for the adoption of hard-to-place children. Any tax benefit, if available at all, should be available only in connection with the adoption of hard-to-place children. It makes little sense to provide Federal aid for the adoption of children for whom there may be a waiting list of willing adoptive parents.

2/ An example of a credit which operates in this fashion is the credit for household and dependent care services necessary for gainful employment. As amended by the Economic Recovery Tax Act of 1981, this credit is 30 percent for taxpayers with adjusted gross income (AGI) of $10,000 or less but drops ratably to 20 percent for taxpayers with AGI of more than $28,000.

2. Dollar-for-dollar credit for adoption expenses (S. 1580). S. 1580 would provide a dollar-for-dollar credit for the amount of adoption expenses which exceed $500 but are less than $3,500 ($4,500 in the case of an international adoption). In effect, this reimburses all taxpayers, regardless of income, for every dollar of adoption expenses over $500 and less than $3,500 or $4,500.

We believe this approach has severe shortcomings. First, a dollar-for-dollar credit gives the taxpayer absolutely no economic incentive to hold down costs (except to the extent they exceed $3,500 or $4,500) because the Government is picking up the entire tab. Second, the same benefits would be available to all taxpayers, regardless of income level. No direct aid program would be structured in this fashion. Finally, as with the unlimited deduction, discussed above, the credit is in no way targeted to the adoption of hard-to-place children.

3. Additional exemption in year child is born or adopted (S.1580). S. 1580 would also provide an additional $1,000 exemption in the year a child was born or adopted ($3,000 for a handicapped child or an adopted child who is a member of a minority race or ethnic group or is at least six years old).

The additional exemption has one of the major flaws of the unlimited deduction -- it provides greater benefits to taxpayers with higher incomes. Moreover, it provides benefits without regard to the actual expenses incurred by the taxpayer. If used in connection with the credit provided by S. 1580, it may result in tax benefits that exceed the taxpayer's expenses with respect to an adoption.

The extra exemption in the year of childbirth poses difficulties in addition to those discussed above. There is no particular reason why the taxpayer's expenses would be higher in this year than in subsequent years of the child's life. Indeed, living and education expenses would ordinarily be greater in subsequent years. Medical costs incurred in connection with childbirth may already be deductible as medical expenses. Thus, it is difficult to understand the logic of this extra exemption.

4. Special treatment of "adoption expense plans" set up by employers (S. 1479). S. 1479 would allow adoption expenses to be reimbursed by employers in a manner tax free to the reimbursed employee. This provision would require I.R.S. personnel to administer the establishment of these plans -- a role for which the Service simply is not suited. Moreover, it would further erode the tax base by exempting from tax yet another element of compensation.

We have one final word on the use of the tax system to provide Federal aid or incentives for adoption. Even if all of the particular concerns voiced above were met, we would nevertheless oppose these various deductions and credits for adoption expenses. We do not believe that the tax system is an appropriate vehicle for providing Federal aid for adoptions. The administration of such an aid program is better done by professionals in the adoption field, not I.R.S. agents. A direct aid program is better scrutinized, more carefully compared with alternative uses of the funds, and easier to alter or repeal if it does not achieve the desired results. There are, to be sure, instances where, notwithstanding these considerations, it is desirable to use the tax system to achieve social goals unrelated to the collection of revenue. However, we must exercise restraint in using the tax system for these purposes. In our view, the area of Federal aid and incentives for adoption is one where the use of the tax system is particularly inappropriate.

S. 425, S. 1348, and S. 1656
Mortgage Revenue Bonds and Veterans Bonds

Both S. 1348 and S. 1656 would amend various provisions of the Mortgage Subsidy Bond Tax Act of 1980 (the "Act"). Although the amendments proposed by S. 1348 relate only to the use of mortgage revenue bonds for single family residences, those contained in S. 1656 would also affect the provisions of the Act relating to the issuance of tax exempt industrial revenue bonds for multifamily housing projects. Treasury opposes those provisions of S. 1348 and S. 1656 which would increase the amount of arbitrage which may be earned by an issuer on mortgage investments either directly, or by altering the mortgage yield computation, and the provisions which would permit issuers to avoid the requirement that reserve funds be reduced as future debt service is reduced.

S. 425 would provide a special transitional rule for $500 million of tax exempt mortgage revenue bonds to be issued by the State of Oregon to finance residences for veterans which would exempt this issue from the provisions of the Act. Treasury is opposed to S. 425.

Treasury would strongly oppose any attempt to extend the mortgage revenue bond provisions beyond their current sunset of December 31, 1983. In addition, we believe that the registration requirement, due to become effective in 1982, ought not be repealed or further postponed.

Background on Single Family Mortgage Revenue Bonds

Prior to the passage of the Act, a great many state and local governments, or duly constituted authorities acting on their behalf, issued tax exempt revenue bonds for the purpose of making mortgage loans for single family residences. The lower tax exempt rate paid on the bonds enabled the issuer to relend the bond proceeds at rates which were below conventional home mortgage interest rates. Generally, the stream of mortgage payments collected from the homeowners and the reserve accounts established from the bond proceeds were the sole security for repayment of the obligations. Although similar to industrial revenue bonds, these obligations were generally not subject to the industrial development bond provisions of the Code because the bond proceeds were not used in a person's trade or business.

Due to the explosive increase in the use of tax exempt revenue bonds for housing during 1978 and 1979, Congress found it necessary to reexamine the relevant tax provisions that permitted the use of these bonds and to impose restrictions on the issuance of such obligations. The legislative history indicates several areas of concern. First, there was concern that a substantial increase in the volume of tax exempt bonds would have a direct effect on the equity and progressivity of our tax system. Second, it was believed that tax exempt revenue bonds were a relatively inefficient method of delivering a subsidy to the housing industry. In particular, there was evidence that mortgage revenue bonds involved relatively high fees and administrative costs, substantially reducing the assistance to the homebuyer. Third, at a time when Congress had otherwise reduced new budget authority for housing, there was concern that tax exempt revenue bonds were a means to effectuate a subsidy to housing while avoiding the budget process. Fourth, there was concern regarding the effect that an expansion of this form of tax exempt revenue bonds would have on capital formation. Finally, there was a fear that the absolute amount of housing bonds, and their growth in relation to the tax exempt bond market in general, would have the tendency to increase the rate of interest for all tax exempt bond issues. The resulting increase in interest costs was seen to increase the borrowing costs for traditional state and local governmental purposes, such as schools, police stations, and streets and highways. H. Rep. 96-678, 96th Cong., 1st Sess. 22 (1979).

The Act incorporated three general types of restrictions which addressed these concerns. First, the Act imposed a limit on the aggregate amount of qualified mortgage revenue bonds which may be issued within any state during a calendar year. The amount of this volume cap is equal to the greater of $200 million or 9 percent of the average amount of mortgages originated in the state in the preceeding three years. This ceiling is determined with reference to mortgages on single family residences. The state ceiling amount is allocated according to a pattern set forth in the legislation among the various governmental units within the state that are eligible to issue mortgage revenue bonds.

Second, the Act contained a series of provisions to limit the amount of arbitrage which may be earned by the issuer. The effective interest rate on mortgages made to homeowners is limited to 1 percentage point above the yield on the bonds. Arbitrage is not permitted on reserves that exceed 150 percent of the annual debt ~~service~~ on the bonds. All arbitrage earnings on nonmortgage investments are required to be paid or credited to the mortgagors or, at the election of the issuer, rebated to the Federal Government. Finally, the Act required that the reserve accounts be reduced as future annual debt service is reduced.

The Act also incorporated a series of program restrictions intended to target the subsidy made available through the use of tax exempt mortgage revenue bonds to those most in need of housing. To this end, the Act requires that mortgages financed with bond proceeds meet a series of eligibility requirements. To ensure compliance with these eligibility criteria three conditions must be met: the issuer is required, in good faith, to have attempted to meet the eligibility requirements for each mortgage; 95 percent of the lendable proceeds must have been placed in mortgages that met particular eligibility requirements when executed; and any failure of a mortgage to meet the eligibility conditions must be corrected within a reasonable time after discovery.

A residence which is financed with the proceeds of a tax exempt mortgage revenue bond must be the principal residence of the mortgagor to satisfy one of the eligibility requirements under the 95 percent test. Another requires that the mortgagor may not have had a present ownership interest in a principal residence at any time during the immediately preceeding three years ("first time homebuyer requirement"). Finally, the acquisition cost of an eligible residence may not exceed 90 percent of the average area purchase price for single family residences in the area in which the residence is located. There are additional restrictions on mortgage assumptions and replacements.

In the case of residences located in "targeted areas," the first time homebuyer requirement is waived and the purchase price limitation is raised to 110 percent of the average area purchase price. The Act defines a targeted area as either a "qualified census tract" or an "area of chronic economic distress." A qualified census tract is a census tract in which at least 70 percent of the families have an income that is 80 percent or less than the statewide median family income. An area of chronic economic distress is an area designated by a state and approved by the Secretaries of Housing and Urban Development and Treasury in accordance with criteria specified in the Act.

Finally, the provisions of the Act permitting the issuance of single family mortgage bonds will sunset on December 31, 1983. After that date, no additional tax exempt single family mortgage revenue bonds may be issued.

On July 1, 1981, temporary and proposed regulations were published in the Federal Register implementing the provisions of the Act relating to single family mortgage revenue bonds. We are presently working on regulations to implement the multifamily provisions of the Act. A hearing has been scheduled on the single family regulations for November 5, 1981. We are currently reviewing and evaluating the comments which we are receiving.

Amendments to the Mortgage Bond Legislation

The Treasury opposes any effort to extend the sunset date of the mortgage revenue bond provisions beyond December 31, 1983. Treasury believes that private purpose, tax exempt revenue bonds are an inefficient method of providing a subsidy, damage the market for tax exempt securities as a whole, and involve a significant loss of Federal revenue. Treasury also opposes the provisions of S. 1348 and S. 1656 which would repeal the requirement that tax exempt mortgage revenue bonds be registered. This requirement is due to take effect with respect to bonds issued after December 31, 1981. Registration does not impose any greater administrative costs on issuers and may even be less expensive than issuing bonds in bearer form in many cases. Further, certain tax exempt industrial revenue bonds are now required to be registered. Finally, bearer securities constitute a convenient vehicle for persons to hold unreported income and to avoid estate taxes.

Treasury opposes those provisions of S. 1348 and S. 1656 which would increase the amount of the arbitrage permitted to be earned by the issuer beyond the current 1 percent level, whether by raising the 1 percent limit to 1.25 percent or 1.5 percent, or by changing the assumptions made in computing the mortgage yield. Treasury also opposes those provisions which would allow issuers to avoid reducing the amount of their reserve accounts.

Treasury intends to make certain changes in the existing regulations, as described below, which we believe address a number of the concerns already expressed.

Changes to the Existing Regulations

As was stated when the regulations were released, Treasury has been monitoring carefully their effect on the issuance of single family mortgage revenue bonds. There have not been many bonds issued under the Act. There are various reasons why this may be the case. Some have argued that the statute is unduly restrictive. Others have argued that positions adopted in the regulations have thwarted the issuance of bonds. We believe that the principal reason that such issues have not gone forward has been the condition of the economy as a whole and the state of the municipal bond market.

The interest rate on long-term tax exempt revenue bonds has increased from 9 percent in December, 1980 when the legislation was passed, to 13 percent in today's market. Tax exempt financing would provide lower interest rates than conventional mortgage financing, but the available interest rate would be 14 percent or higher. This high mortgage interest rate puts even these monthly payments beyond the reach of many first time homebuyers. We expect that the housing market will improve considerably when interest rates, including tax exempt yields, decline.

Nevertheless, we have reviewed the comments which were submitted on the temporary and proposed regulations for single family mortgage revenue bonds and have decided to make certain changes in these regulations to address problems which have been raised. We will be coordinating these changes with the Internal Revenue Service and would expect to issue amendments to the temporary and proposed regulations in the relatively near future. These amendments would include the following changes:

- 95 percent requirement

The regulations would be amended to incorporate a series of administrative "safe harbors" for purposes of determining whether the eligibility requirements for mortgages under the Act have been met.

° Partial use of residence in a trade or business

The regulations would be amended to provide that a use of a residence which does not give rise to a deduction allowable under section 280A would not constitute a "use" in a trade or business. Furthermore, we expect to promulgate a rule for residences, a portion of which are used in a trade or business, e.g., as an artist's studio or a barbershop. Such a rule would treat a property that was primarily occupied as a residence as a "principal residence" if less than a specified percentage of the property is used in a trade or business.

° Definition of "temporary initial financing"

The regulations would be amended to redefine this phrase to include loans having an initial term of 18 months or less.

° Participation fees

The regulations will be modified so that origination fees, or "points," retained by the issuer will not be treated as proceeds from nonmortgage investments in all events, as the regulations now provide. This change will make it easier for issuers to demonstrate "parity" -- that pledged assets equal the face amount of the bonds.

It is our hope that these and other changes which we will be making in response to the comments on the regulations and the statements at the hearing on the regulations will assist issuers in proceeding to market with issues.

Arbitrage Restrictions

The arbitrage restrictions contained in the Act were designed to make the delivery of the housing subsidy as cost-effective as possible. The arbitrage restrictions did this by limiting the amount of profit which could be earned by an issuer. To the extent that the spread between the yield on the mortgages and the yield on the bonds which were issued to provide the mortgages is kept low, most of the subsidy provided by the lower tax exempt interest rate is passed on to the ultimate users of the proceeds. To this end, the Act contains a series of provisions to restrict the permissible arbitrage and to require that any excess be returned to the mortgagors or paid to the United States.

Both S. 1348 and S. 1656 would increase the amount of the allowable arbitrage on mortgage investments, thereby increasing the inefficiency of delivering the subsidy through tax exempt bonds. S. 1348 would permit an issuer to earn 1 1/2 percentage points over the bond yield on its mortgage investments. It would also alter an assumption regarding mortgage prepayments now contained in the regulations so as to provide the issuer from between 4 and 15 additional basis points. S. 1656 would increase the arbitrage limit for mortgage investments to 1 1/4 percentage points over the bond yield. Under each bill, an issuer would be relieved of the requirement to reduce its reserve investments if the loss from the disposition of such assets would exceed the current cumulative arbitrage earnings.

The Treasury is opposed to these changes in the arbitrage provisions. First, there is no demonstrable evidence that the 1 percent restriction is a bar to the issuance of these obligations. Second, the real issue is whether the costs associated with the issue and the issuer's program should be paid out of the arbitrage on mortgage investments -- and ultimately by the mortgagor in the form of higher interest costs. In our view, the delivery of this housing subsidy should be regarded as a joint Federal and local program, and not as a program in which the Federal Government supplies 100 percent of the subsidy. To the extent that the current arbitrage limit does not allow recovery of all these costs, issuers will be required to make some contribution to the bonds or to absorb some of the costs. From the Treasury's perspective, the current arbitrage limit is a workable restriction. The state or local government participates by administering the program and, where necessary, by absorbing some of its costs. This, of course, creates an incentive for an efficient program which, in the final analysis, means a lower interest cost to the mortgagors. The 1 percent arbitrage limitation is an effective way to make the delivery of the subsidy cost effective to the users and to bring some degree of financial participation to the program by the state or local governments involved.

Treasury is also opposed to the provisions of these bills that would allow the issuer to retain reserve fund assets if their sale would produce a loss in excess of the current cumulative arbitrage earnings. These arbitrage earnings are required to be paid or credited to mortgagors (or the Federal government). Thus, they would not be available to protect against default under the bonds because of the prior claim of the mortgagors. This refinement should not be adopted in view of the lack of a clear need. The arbitrage provisions should be amended, if at all, only after a sufficient volume of bonds has been issued so that there is some experience to evaluate these provisions.

Summary of Treasury Position on Single Family Bonds

Treasury believes that it is important to keep a firm rein on the budget outlay represented by single family mortgage revenue bonds and to ensure that the delivery of the benefits provided by such bonds be accomplished in a cost effective manner. Accordingly, we strongly oppose any relaxation of the 1 percent arbitrage restriction and any alteration in the state by state volume ceilings. Moreover, Treasury opposes any extension of the mortgage revenue bond provisions beyond the sunset provided for in the Act and also opposes any deferral or elimination of the registration requirement scheduled to go into effect for bonds sold after December 31, 1981.

Provisions Relating to the Issuance of Multifamily Housing Bonds

In addition to imposing restrictions on the issuance of single family mortage revenue bonds, the Act also imposed additional restrictions on the issuance of tax exempt bonds to provide multifamily housing. Unlike single family mortgage revenue bonds, multifamily housing bonds generally constitute industrial development bonds because the proceeds of the bond issue are used in the trade or business of the person owning the housing project. Although there are no volume caps on the aggregate amount of multifamily housing bonds, and these provisions do not sunset in 1984, the Act did attempt to target part of the subsidy to low and moderate income renters.

Under the Act, interest on an industrial development bond, substantially all the proceeds of which are used to provide a qualifying project for residential rental property, is exempt from Federal income tax. Generally, a project is treated as qualifying under the requirements of this provision only if 20 percent or more of the units in the project (15 percent for a project in a targeted area) are to be occupied by individuals of low or moderate income. Generally, the term "low or moderate income" is determined by the Secretary in a manner consistent with the Leased Housing Program Under Section 8 of the United States Housing Act of 1937. The statute contains a specific transitional rule for multifamily issues requiring that the period for which the 20 percent requirement must be met, for bonds issued before January 1, 1984, is 20 years. We are working with the Department of Housing and Urban Development to develop regulations to implement these provisions of the Act.

Certain problems have been raised regarding the operation of the multifamily provisions. S. 1656 would amend the targeting provisions of the Act to clarify the definition of an "individual of low or moderate income" and to reduce the period of time during which the 20 percent requirement must be met to the greater of 10 years or 1/2 the term of the obligations.

Treasury is preparing a proposal on the treatment of tax exempt revenue bonds in general. We believe that these amendments, even though of a technical nature, should be considered in the context of the changes to the structure of tax exempt revenue bond financing which we will be proposing. Changes in this area ought not be carried out in a piecemeal fashion.

S. 425

S. 425 would amend the transitional provisions of the Mortgage Subsidy Bond Tax Act to provide that an issue of $500 million of general obligation bonds of the State of Oregon would be exempt from the substantive provisions of the Act. The proceeds of the bonds would be used to provide mortgages for veterans. The Treasury is opposed to S. 425.

The Act contained numerous transitional rules which exempted from the restrictions of the Act a significant number of bond issues which were in progress during the consideration of the Act. In addition, there was an overall transitional provision which exempted from the provisions of the Act obligations issued prior to January 1, 1981, which were part of an issue which is, before a date which is one year after the date of issue, committed by firm commitment letters. Nevertheless, S. 425 seeks to carve out an additional rule for transitional relief almost one year after the fact. The Treasury's opposition to S. 425 is two fold. First, if transitional relief was necessary, the appropriate occasion to obtain transitional relief was prior to the passage of the legislation. Numerous other issuers came forward, identified their programs, and were granted relief. The State of Oregon should not be treated otherwise or an unfortunate precedent would be set which would invite similarly situated issuers to come forward for transitional relief. Secondly, the special rule would apply to two outstanding issues by the State of Oregon, one of which went forward in April. Especially in the latter case, there was ample time to adjust to the provisions of the new law. Given that there was ample notice, Treasury opposes legislation which would grandfather an issue after it has been sold.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Secretary CHAPOTON. Good morning, Mr. Chairman. As you pointed out, we have a rather lengthy statement, and what I am going to do is summarize it very briefly. I would be happy to expand on any points you might like us to expand on, and answer any questions.

Senator PACKWOOD. Let me just ask. I have been reading your first page. It looks like that, with one or two minor exceptions of one or two of the bills, your Department is firmly opposed to all of the bills and all of the provisions. Does that roughly summarize your statement?

Secretary CHAPOTON. I am not sure I would want to summarize it that way. But when I go through the details, Mr. Chairman, I think it is what some people call the traditional Treasury response. [Laughter.]

Senator PACKWOOD. We had a bill last hearing that you supported. I can't remember what it was. It stunned me at the time. [Laughter.]

Secretary CHAPOTON. Well, there are some matters in here that we want to talk about. On the adoption provisions, S. 608 and S. 1479 both provide adoption expense deductions that are unlimited in dollar amount. We are expressing in our testimony our traditional concern that when you have an allowance through the tax system that does not take need into account or does not provide a phaseout, and, indeed, that is a deduction as opposed to a credit, then we question whether it is a proper way to provide relief in a need area.

In addition, we point out that in those two bills there is no targeting to provide aid for hard-to-place children, so the benefit would be available even in cases where there may be a waiting list of willing adoptive parents.

S. 1580 provides a credit. It is a dollar-for-dollar credit for adoption expenses over $500 up to a cap of, I believe, $3,500, or $4,500 in the case of an international adoption. We just point out that the credit would leave no incentive for the taxpayer to hold the cost down. Up to those limits, the credit would constitute a total picking up of the cost by the Federal Government through the tax system. And we would oppose that. Also, S. 1580 would provide an additional $1,000 exemption in the year a child is born to, or adopted by, a taxpayer. The exemption would increase to $3,000 in certain cases. We would just point out that, although there are additional expenses in adoption, these are, of course, basically personal expenses. Moreover, there are additional expenses when the children are raised. Indeed, in later years, the expenses of education might even be greater than the expenses for the earlier years. Thus, we raise the question whether there would be any special need for the exemption in the year of birth or adoption.

And, finally, S. 1479 provides for adoption expense plans which would follow in general respect the model of medical reimbursement plans where the amounts provided by an employer would not be included in the employee's income. We would not like to get the IRS into the business of having to approve such plans and having to determine whether particular types of benefits are appropriate in particular cases under approved plans.

I would also point out that this committee has adopted additional tax free benefits in other areas. We do need to watch the trend to do that because it does erode the tax base to an extent.

Senator PACKWOOD. Let me ask you a question about this particular point. The IRS is not involved under this amendment, as far as I read it, any more than they are in any of the others. You are simply to make that the plan does not discriminate in favor of highly compensated employees.

Secretary CHAPOTON. That is correct.

Senator PACKWOOD. And that is all you have to pass on.

Secretary CHAPOTON. That is correct. But we do have to approve the plan. And that, itself, is a difficult question. That is a very difficult question.

Senator PACKWOOD. Well, you are willing to support the bill. We would take that out. You wouldn't have to pass on it at all. Just simply make them tax free fringe benefits. And the IRS never does pass on the plan.

Secretary CHAPOTON. Well, I would still have the question I raised earlier, whether you want to erode the tax base for this type of fringe benefit. And as we tried to point out in the testimony, we are talking about providing a benefit through the tax system that really is unrelated to the tax system. That is a traditional point we make. And I understand there are cases where that is desirable because there is efficiency in doing it without bureaucracy. But we do have a case here where need is involved. I take it that the purpose of these types of provisions is to provide relief because there is a type of need. It seems to me that if we do that there ought to be some targeting involved.

Senator PACKWOOD. We go through a debate each time we have this. The administration really doesn't object to the use of the tax system for social objectives because they have already introduced a variety of tax incentives. The use of the tax system for social objectives of this administration—and every administration does—the only objection any administration has, Republican or Democrat, to the use of the tax code for social objectives is if it is not for their social objectives. But I never find any consistency. I have yet to find an administration that really is for uniform tax reform and getting rid of the mortgage interest deduction, and getting rid of dependency deductions, and getting rid of the medical fringe benefits, and everything, and using the code solely for the collection of money. And I don't think that is the position of this administration.

Secretary CHAPOTON. Mr. Chairman, on that question, cost generally comes up. And certainly I have to concede there is much truth in your point. However, a lot of items are in the code that, perhaps if we were redesigning the code, we would not put them in now. I think we do have to examine further erosion with that point in mind. The items you mention are ones that we might well look at again if they were being proposed for the first time now. Once they are in, it is very hard to get them out.

Senator PACKWOOD. One is not in there yet. But I recall one time I was accused of wanting to put in the code a tax free benefit for auto repair. Somebody was carrying this theory to an extreme. And I am not going to tell you which company because you would go seek them out, I think. One company came up to me afterward and said they had auto care for their employees. They were a suburban company in a major town. They had too much downtime with people coming in late because they were leaving their cars for repair and leaving early to pick up their cars. So they set up an auto repair facility on their parking lot. And, initially, they provided it at cost for their employees. The person that was talking to me—and this was, oh, 8 or 9 years ago now, and I check every couple of years and they still have it—he said that will be a fully employer-paid fringe benefit within 10 or 12 years.

I asked him how the employees liked it. He said, "Like it? We could get rid of health care and vacations before we could get rid of auto care." [Laughter.]

Senator PACKWOOD. And that is not at the moment tax exempt, by statute, so I am not going to tell you which company it is.

Secretary CHAPOTON. Well, Mr. Chairman, I have heard that same story. [Laughter.]

Secretary CHAPOTON. Indeed, it is an example of a growing type of fringe benefit. The assertion in that case is that it is a type of fringe benefit which is under the prohibition against our dealing further with new types of fringe benefits. It is certainly not specified as tax free in the code.

Senator PACKWOOD. I think it is justified. It just is not in the code yet.

Secretary CHAPOTON. Turning to the mortgage revenue bonds and the veterans bond provisions, let me very briefly just trace for you where the 1980 legislation brought us. It did, as you know, put a sunset provision on the use of tax exempt bonds to finance single-family mortgages. That is, tax exempt bonds to provide single family mortgages cannot be issued after December 31, 1983. For bonds issued prior to that date, the scheme is that there is a volume cap, a per State volume cap, equal to 9 percent of the average volume of mortgages originated in the 3 preceding years, or $200 million, whichever is higher.

There is an arbitrage limit, a series of limits, designed to limit the arbitrage profit available as a result of the issuance of mortgage revenue bonds. Basically, this consists of a 1-percent limit on arbitrage from mortgage investments, a requirement as to the size of reserves that are composed of nonmortgage investments, and a requirement that the arbitrage profits on mortgage investments be paid over either to the mortgagors or to the Federal Government.

And, finally, there are program restrictions—eligibility requirements, if you will—that must be met with respect to the mortgages financed with the proceeds of each bond issue.

Let me just say in general terms that we would oppose any extension of the sunset provisions. We would also oppose the provisions of 1348 and S. 1656 that would repeal the requirement that the tax exempt mortgage revenue bonds be registered. That requirement goes into effect next year. We think it is a good requirement. Indeed, we think there is a problem in the use of bearer bonds to assist in avoidance of income tax and in avoidance, in some cases, of estate tax.

Senator PACKWOOD. Do you think the registration will raise the cost of the bonds any?

Secretary CHAPOTON. We do not think the registration will raise the administrative costs. Indeed, there is some evidence that it will reduce the cost associated with issuance.

We would also oppose any increase in the arbitrage permitted to be earned by the issuer in excess of 1 percent on mortgage investments. I would simply point out to the committee that this may have the effect of making the local issuer become involved in the issue in a financial way in some cases. That is, the delivery of the subsidy, the Federal subsidy, might require some degree of financial participation by the State or local government that is issuing the bonds. I think that was a conscious decision by the tax writing committees last year, and we think it brings responsibility to the area, a definite degree of responsibility. We think that the current arbitrage provisions are good requirements.

There are definite problems, Mr. Chairman, in the application of the 95-percent requirement in the mortgage eligibility provisions. We issued regulations, I believe in early July, and we will have hearings on those regulations in early November. I am personally convinced that the 95-percent test is having the effect of preventing issuance of some bonds. Therefore, we are going to amend those regulations in a way which would incorporate a series of "safe harbor" provisions for testing whether a mortgage meets the eligibility tests. We cannot, of course, write out the 95-percent test. As long as there are eligibility criteria in the statute—and there is a 95-percent test—we must live with it as well as the issuers. But I think we can provide some relief through a "safe harbor" mechanism, and we will be proposing amendments in that regard soon, prior to the hearing.

We also will modify the regulations to provide relief in the area of where a residence is used in small part in a trade or business. The proposed regulations may prevent the financing of repairs or improvements or even the financing of such a residence where some minor business use is involved. We are going to provide relief in that area. We are going to redefine the term "temporary initial financing" to include loans having initial terms of 18 months or less rather than the shorter period now set forth in the regulation. And, finally, we want to make it clear that we will modify the regulations so that origination fees, or points, which are retained by the issuer will not be treated as proceeds from nonmortgage investments in all events, as the regulations now provide. This will make it easier for issuers to demonstrate parity, that is, pledged assets will equal the face amount of the bonds.

There will be other changes in the regulations, and, as I said, there will be a hearing on November 5. We want to be responsive to the comments that have been received and the comments that will be received at the hearing.

Last year's act also dealt with the multifamily housing area. Multifamily housing bonds do constitute industrial development bonds because the proceeds are used in a business. There are administrative problems that are sought to be corrected by S. 1656, particularly problems with the definition of "low- or moderate-income persons" and the time period over which the facility must

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be occupied at least 20 percent by a person of low or moderate income. We agree these are both problem areas. We are making a proposal, as you know, dealing with industrial development bonds and we prefer that this type of amendment, which is technical in nature, be dealt with in the context of industrial development bond changes.

Finally, S. 425 deals with the Oregon veterans' bond situation. Mr. Chairman, we have to oppose additional transitional relief for these issues. The very carefully constructed—and, I concede, very tight—transitional rules of the statute as enacted last year were much thought over, and represented compromises. We simply would not want to get back into further transitional relief at this time. To make the two issues involved eligible, we would be redefining both the residence requirement and the restriction against using bond proceeds for it, and we would have to oppose that.

Senator Packwood. You do concede, however, that at the time the limitations were passed last year it was presumed that those two Oregon bond financings be covered. We thought we had taken care of it then.

Secretary Chapoton. I have understood that it was presumed in Oregon. I, frankly, do not understand how that miscommunication occurred.

Senator Packwood. It occurred because of the last administration, but I can't hold you responsible. [Laughter.]

Senator Long. No questions, Mr. Chairman, because I want to ask this witness questions later on in the executive session. I would like to ask that a statement of Senator George Mitchell, supporting Senator Sasser's position, appear in the record.

Senator Packwood. Without objection.

[The prepared statement of Senator Mitchell follows:]

Prepared Statement by Senator George J. Mitchell

Mr. Chairman, I wish to express my support for S. 1348, legislation introduced by Senator Sasser to amend several provisions of the Mortgage Subsidy Bond Tax Act of 1980. I am pleased that the Subcommittee on Taxation and Debt Management has scheduled this hearing as a forum is urgently needed to air the problems generated by that Act.

I speak today as a cosponsor of the measure, and as one who believes that tax-exempt single family housing bonds are an important source of mortgage credit, especially in these troubled times, and that their use, within limitations, must be allowed.

After serious abuses were revealed on the part of some bond issuers, Congress correctly decided to curb the use of these bonds. Taxpayers clearly should not subsidize the sale of homes for those who can afford to obtain financing on their own.

However, in its zeal for reform Congress placed so many restrictions on the issuance of bonds that it effectively curtailed their use. Since January of this year, virtually no bond issues have been sold in this country to support single family home mortgages. Given the depressed condition of the housing industry and persistently high interest rates, this is only exacerbating the frustration of prospective home buyers and the demand for mortgage credit.

While I agree wholeheartedly that we must root out abuse and to the extent we can, the potential for abuse, I believe it is shortsighted to eliminate all use of these bonds. There are many instances in which the bond proceeds have been used to serve low and moderate income families, people who could not otherwise afford to buy a home of their own.

I am proud to say that in my own State of Main, such a program exists. Since 1972, the Maine State Housing Authority has used mortgage revenue bonds to provide lower interest rate mortgage funds to residents of the State who meet the program's income guidelines. Under its auspices, over 5,000 Maine people have thus far been able to buy a home of their own.

During this period, both the Maine State Housing Authority and the State Legislature have acted to ensure that this source of assistance is available only to those individuals who need it. The maximum income limit is $20,000 and the purchase price of a home cannot exceed $45,000. Also, a borrower asset limit of 50 percent of the home purchase price has been established.

The Maine Legislature exercises careful oversight of the program to ensure that funds are being used appropriately. Further, it has set a limit on the amount of money the Authority can borrow in the national bond market, a limit reviewed regularly as to the need for alteration. And finally the enabling legislation for the Housing Authority specifically requires that mortgages made available through these bonds can only go to those individuals unable to get credit in the conventional mortgage market.

With such features, the program has earned then support of the builders, bankers and the real estate industry in Maine. Indeed, given the limited availability of mortgate credit, a number of lenders have said that if the bond subsidy program had not existed last year, there would have been virtually no single family mortgage market in the state.

I would now like to address three specific problems created by the Mortgage Subsidy Bond Tax Act and addressed by the legislation before this committee.

First, the most troublesome provision enacted into law last year dealt with arbitrage—the one percentage point limit established between the interest rate on the bonds sold and the interest rate on the mortgages made available with the use of bond proceeds. The Tax Act further required that essentially all of the charges associated with the bond issue or incurred by the mortgage borrower be paid for out of the one point spread.

The effort to contain costs associated with bond issues and the charges borne by borrowers has merit. Unfortunately, the combination of the reduced arbitrage limit and the requirement that the limit absorb all costs and charges has produced an untenable situation. Specifically, the new limitation effectively prevents the Maine State Housing Authority from having enough money to finance the sale of the bond issue and, at the same time, assure the bond holders of proper program administration and retirement of the debt obligation.

A state ~~such~~ as Maine, with its small population and tax base, cannot issue bonds in sufficient numbers to realize the revenue necessary at the one percentage point limit to make such a mortgage program financially viable. In other words, a small bond issuer cannot realize the economies of scale that a large issuer such as New York or California could under similar circumstances.

Further, if small issuers are forced to use their own funds to support bond issues, they will in the process undermine their own financial strength. And, the issue of outside support runs contrary to the established premise that revenue bonds should be amortizable solely from revenues. No other revenue bond is forced by operation of federal law to be similarly subsidized.

It is for these reasons that restoration of the one and one-half percentage point arbitrage limit is necessary to permit well intentioned programs in small, rural states such as Maine to go forward.

Second, under current law, a bond issue will lose its tax exemption if it fails to meet certain enumerated requirements. While I do not dispute the need for an issuer to exercise good faith in meeting all requirements imposed, it seems particularly onerous to penalize the bond issuers and bond holders if the borrowers, over whom they have no direct control, failed to convey proper information about their qualifications. The legislation before us today still requires the issuers to use good faith in meeting all statutory requirements, but enables them to correct any failure to meet those requirements within a reasonable period after the failure is discovered.

In this manner, the legislation provides for a fairer method of compliance while preserving the issuer's responsibility for acting in good faith.

Finally, I wish to address the targeted area requirement of the Mortgage Subsidy Bond Tax Act which provides that a portion of bond proceeds be made available for a period of at least one year for mortgages in targeted areas within an issuer's jurisdiction. A targeted area is defined as either a qualified census tract or an area of chronic economic distress.

Unfortunately, census tracts are limited to the few urban areas in Maine, requiring that the bulk of the state be designated as an area of chronic economic distress. And such designation is subject to approval by the Secretaries of Treasury and Housing and Urban Development according to criteria not easily definable in rural states.

The approach taken in the legislation before us would limit the percentage of the geographic area within a state that could be targeted and gives the state final decision-making authority in the designation of areas of chronic economic distress. This approach is simpler and more sensible and removes the red tape currently prescribed by law.

Mr. Chairman, I heartily endorse the legislation proposed to remove some of the more onerous restrictions of the Mortgage Subsidy Bond Tax Act of 1980. I wish to emphasize that in urging passage of this legislation today, I do not intend to reopen mortgage revenue bonds to abuse. Rather, I believe that responsible programs like the one in Maine, serving low and moderate income people, should be protected and permitted to go forward.

I hope this Committee will act promptly and favorably in reporting the bill to the full Senate.

Senator PACKWOOD. John, thank you very much. You are a very durable witness.

Secretary CHAPOTON. Thank you, Mr. Chairman.

Senator PACKWOOD. I say that to him kindly. He has to come up here about every 2 weeks when we have hearings on a variety of bills and, by and large, represent a negative position on them in front of a committee that is in favor of most of the provisions and an audience that is fully in favor of them. [Laughter.]

Let's move on now to S. 608, S. 1479, and S. 1580. And we will start with a panel consisting of William McKay, Pat Buchanan, Paul Bankerd, and Douglas Johnson.

I would ask if you could to also abbreviate your statements. I have read the statements that I had from the witnesses as of last night. I have not read the ones that may have come in this morning. All right. Mr. McKay.

STATEMENT OF WILLIAM E. McKAY, CHAIRMAN OF THE NATIONAL COMMITTEE FOR ADOPTION, WASHINGTON, D.C.

Mr. McKAY. Mr. Chairman, my name is Bill McKay. I am chairman of the board of the National Committee for Adoption, which is a national group made up of agencies and individuals who support adoption. I am a Fort Worth, Tex., businessman, and I should be here this morning, I guess, speaking on deductions for auto repairs or an Auto Dealers' Survival Act. But I think I have made the right committee meeting to talk about adoption.

I am also a proud adoptive father and an adoptee. And I am the treasurer of the Fort Worth agency, the Edna Gladney Home. I will summarize my remarks and ask that the full statement be made part of the record.

I want to thank the subcommittee for this opportunity to testify on legislation which would improve lives for children by making three changes in the tax code. We are especially pleased to strongly endorse the provision making expenses for adoption deductible when arranged through agencies. This not only encourages adoption but encourages the best kind of adoption, we feel, which is carried out by an accountable, licensed, and professional group of people. This provision is included in both S. 608, sponsored by Senator Baucus, and S. 1479, sponsored by Senator Metzenbaum. International adoptions arranged by agencies would be covered also. So we support both of these bills and urge favorable action by the subcommittee.

We also endorse two other recommendations. Adoption expense benefits which are provided as fringe benefits should not be taxable to the employee, and those companies which provide adoption expense benefit programs should be able to treat these expenses as an ordinary and necessary business expense.

S. 1479, sponsored by Senator Metzenbaum, includes these amendments which we support, and we are grateful to Senator Metzenbaum for his efforts on behalf of building stronger American families through adoption, which he talked about this morning.

Several Senators deserve special praise for their work on the issues. Senator Baucus took an early and committed interest in promoting adoption by introducing S. 608. And I want to personally record my thanks to Senator Bentsen, from Texas, a member of this subcommittee, for his persuasive efforts during the conference on the Economic Recovery Act which resulted in the enactment of the first tax deduction for adoption expenses.

We are hopeful that this hearing record will assist in seeing that important deduction for the adoption of special needs children is expanded to include all children who are adopted through agencies, including infants and orphans from other countries. Senator Jepsen has also led this fight.

The issue before the Senate is simple. Tax deductions for adoption expenses work. Among the States where the deduction works is Minnesota, a State that also protects all those involved in adoptions by requiring all adoptions to be arranged through licensed people. Senator Durenberger has supported tax deduction measures in the Senate consistently.

Another State that has the tax deduction in its code is California. The California bill was signed into law by the then Governor Reagan. We hope that even though officials in the Treasury Department testified in opposition to tax deduction legislation for adoption this morning, that President Reagan will have the opportunity to do for the country what he did for California and that the Congress will present him with an appropriate bill he can sign during 1981.

We are concerned about four items related to tax deductions for adoption. First, no deduction bill should be approved which allows a tax benefit for independent adoption expenses. There are too many tragic cases of this risky practice involving helpless children and vulnerable parents for such independent adoptions to be encouraged by the tax code.

Second, there should be no artificial limit on the fees which can be deducted. By limiting the deductions to licensed agency placements, appropriate accountability will be assured them.

Third, we commend Senator Jepsen for his tax credit alternative. We hope this valuable addition to the tax deduction approach is considered by this committee.

Fourth, we ask that careful review be given to the recently enacted $1,500 deduction for adopting special needs children to insure that all such children, not just those who are determined eligible by the State welfare department, would be included.

Thank you very much for this opportunity to testify before your subcommittee, Chairman Packwood. We believe that building families through adoption is a very positive social institution which should no longer be ignored by our Federal Government or its tax policy. Adoption is a good investment in this country's future. By encouraging loving families to adopt, hopeless, neglected, and unhappy children can be brought up to be healthy, happy, and productive citizens. To me that is good business sense.

Thank you, Mr. Chairman. I would be happy to answer any questions that you might have.

Senator PACKWOOD. Mr. McKay, thank you. I think I will let the panel finish first. Pat Buchanan.

STATEMENT OF MS. PAT BUCHANAN, PRESIDENT, MARYLAND REGION CHAPTER OF THE LATIN AMERICA PARENTS ASSOCIATION, SEAFORD, N.Y.

Ms. BUCHANAN. Mr. Chairman, my name is Pat Buchanan. I am here today to testify and offer comments on Senate bills S. 1580, S. 1479, and S. 608. I present these comments on behalf of the Latin America Parents Association, a volunteer, not-for-profit national organization whose members have either adopted, or plan to adopt, children from a Latin American country. At this time our organization has its headquarters in New York with chapters in Maryland, New Jersey, Connecticut, and Pennsylvania. Our current membership of about 1,000 families reside in 37 different States. Over the years we have watched, supported, and been heartened by the attempts and steady progress to have thousands of children in the foster-care system released for adoption. We are especially pleased with the recent actions taken by this committee to allow a tax deduction for the adoption of a child who is handicapped, over the age of 6, or who is a member of a minority race or ethnic group.

The recognition by this committee of the financial burden on adopting families is a major step forward. However, I hope this committee comes to understand and appreciate that almost all adopting parents, in their attempts to bring children into permanent and love-filled relationships, incur large financial burdens that are in no way reimbursed through medical plans, nor are they allowed as tax deductions or tax credits to help defray costs. This committee, by positive action, can help provide some financial relief to adopting parents. The three bills all attempt to provide relief in this area. Each could be modified to provide greater equal treatment to all adopting parents.

As you might imagine, we see S. 1479 and S. 608 as falling short in providing relief for all adopting families. The wording in both of these bills would seem to exclude two specific groups who adopt, those completing intercountry adoptions, and those who have a child placed with them by the birth mother. All intercountry adoptions, with the possible exception of some children from Korea, depending upon eventual interpretation—this because many children from Korea are placed through U.S. agencies—could be excluded.

These two bills give no consideration whatsoever to the approximately 5,000 children that are placed for adoption here in the United States each year by various public welfare departments or volunteer, not-for-profit orphanages licensed in foreign countries. Most of the adoptions that are coming from the Latin American countries now, numbering some 200 a year, are coming through the direct method, and we feel that it is not in our best interest to be discriminated against. And we hope that you will take this into consideration.

We feel that the attitude in these two bills on the subject of direct placements are, (1) an agency always knows best, and (2) there is something tainted with direct placement. Neither of these attitudes are correct. Direct placements work as well as agency placements, and television and newspaper stories notwithstanding, we believe that most direct placements are done in a legal manner.

Attached to the statement that I gave to the committee in advance are statistics obtained from official INS records showing the number of intercountry adoptions from 1969 through 1979. These figures support our recommendation that expenses incurred through intercountry and direct adoptions be included. I ask the permission of the chairman to include this information in the hearing record. Thank you.

Senator PACKWOOD. It will be included in the record.

Ms. BUCHANAN. Thank you for the opportunity to present my statement.

Senator PACKWOOD. Thank you very much.

[The list of statistics follows:]

Latin America Parents Association
NATIONAL HEADQUARTERS • P.O. BOX 72 • SEAFORD, NEW YORK 11783

To: National President, Chapter Presidents &
Director of International Adoptions

August 1981
Planning Conference

From: Terry Kelly, Legislation Committee

Intercountry Adoptions by Region:

	'69	'70	'71	'72	'73	'74	'75	'76	tq 76	'77	'78	'79	
Europe	599	609	488	361	388	325	265	196	70	159	141	141	
Asia xKorea	404	482	498	529	793	1138	1308	1185	501	1062	714	733	
Korea	775	851	1174	1585	2183	2453	2913	3859	988	3858	3045	2406	
Oceiana	35	35	9	18	17	11	16	14	1	19	18	6	
Africa	14	17	27	23	13	25	21	22	10	26	15	19	
Canada	273	337	345	355	289	188	133	97	23	57	93	66	
Latin Amer incl. Mexi	62	90	183	152	332	630	977	1179	405	1312	1289	1493	→ 31%
TOTAL 3%	2162	2421	2724	3023	4015	4770	5633	6552	1998	6493	5315	4864	

Note: Years thru '76 were 12 month periods ending in June
tq is transition quarter June30 1976 thru Sept 30 1976
Years '77 thru '79 were 12 month periods ending in September.

Source: Immigration & Naturalization Service, Washington, D.C.

Observations:

The numbers above explain why waiting times for placements from Latin America have increased so dramatically in recent years. Since 1977 total Intercountry Adoptions have declined by 25%. The termination of placements from Vietnam and a reduction by 38% of placements from Korea account for the majority of the decline. The increase in placements from Latin America of about 200 children is in comparision to a decline of about 1,700 placements from Asia including Korea.

Placements from India and Poland have shown some increase during this period.

The results of our research efforts can be seen in the increased placements from Chile and Peru. (See detail on next page.)

Over the past three years the majority of the placements in Latin America have come from six or seven countries, about 80%. Approximately 21 other countries place the remaining 20% of the children with American parents.

1977		1978		1979	
Colombia	44%	Colombia	47%	Colombia	42%
Mexico	12	Mexico	12	Mexico	9
El Salv.	10	El Salvador	8	El salvador	9
Costa R.	6	Costa Rica	7	Costa Rica	7
Guatemala	4	Guatemala	4	Chile	6
Nicaragua	3			Guatemala	5
				Peru	5
	79%		78%		83%

	'69	'70	'71	'72	'73	'74	'75	'76	TQ	'77	'78	'79
Antigua										2		2
Argentina									2	4	3	7
Bahamas									1	3		1
Barbados										1		
Belize									1	3	2	2
Bolivia									6	17	16	16
Brazil	—		7	8	20	20	26	25	5	39	15	25
Chile									10	34	36	90
Colombia		13	23	35	107	245	379	554	178	575	599	626
Costa Rica		9	23	7	14	23	94	115	38	83	87	100
Dominican Republic									3	15	17	14
Ecuador				8	21	40	61	42	22	28	42	39
El Salvador							69	86	35	132	98	139
Crenada										4		1
Guatemala			5			24	31	42	17	52	51	75
Guyana										5	2	15
Haiti									1	4	7	1
Honduras				5	13				8	29	24	19
Jamaica		14	10	6	7	18	25	23	9	28	27	33
Mexico	26	21	71	44	85	129	162	127	46	156	152	139
Nicaragua				5	2	18	15	17	5	42	29	46
Panama			9	9	13	20	21	27	11	25	26	25
Peru			6	4	7	18	15	15	2	11	35	72
St Christopher										1	3	
St Lucia										1	2	
Trinidad&Tobago									2	9	7	1
Turks&Caicos Isd.										1		
Venezuela										7	3	1
Other	56	41	26	21	43	75	79	106	2		2	3
	82	98	180	152	332	630	977	1179	401	1311	1285	1492

ote: Years thru '76 were 12 month periods ending in June. TQ is transition quarter 6/76 9/76. Years 77 thru 79 are 12 months ending September30.

Senator PACKWOOD. Mr. Bankerd.

STATEMENT OF PAUL BANKERD, ADOPTIVE PARENT VOLUNTEER, NORTH AMERICAN COUNCIL ON ADOPTABLE CHILDREN, INC., WASHINGTON, D.C.

Mr. BANKERD. Good morning, Mr. Chairman. I am Paul Bankerd. I am speaking on behalf of the North American Council on Adoptable Children. We are a broad-based citizen coalition with over 480 local chapters all across the United States, and a combined membership of more than 20,000 adoptive families and citizens who are concerned about the needs of children who are without permanent homes.

I am an adoptive parent. I have been active for many years in the North American Council on Adoptable Children, and in its local affiliate, the Council on Adoptable Children, of Washington, D.C. I am a member and former chairman of the social services advisory board of the city of Alexandria, Va. Professionally, I am a management expert and an income tax consultant. I have a keen interest, both personally and professionally, in the legislation that we are talking about today.

The North American Council on Adoptable Children was pleased that the Economic Recovery Act of 1981 included provisions for a deduction for the expenses of adopting special-needs children. We are concerned, however, that the eligibility requirements of that deduction could be unnecessarily restricted. Eligibility is dependent, according to the law, upon benefits received under other legislation. And because of this, the ability of families to participate in this benefit could be limited due to future changes in appropriations, due to amendments to the funding measures which are unrelated to the tax law, or due to restrictive interpretations by the Internal Revenue Service. All of the proposed bills that we are talking about today would correct the potential problem we see here, and would go beyond the current law by recognizing and encouraging adoption as a viable means of building families, not only families for children with special needs, but for all children in need of permanent homes.

I think every single member of the council who is an adopted parent has found that adoption is truly a viable means of building a family, and it is in no way a second choice for adding children to the family.

And I feel it is entirely appropriate that the legal and administrative expenses of adoption have the same tax treatment and the same benefits as the medical expenses of giving birth.

We are concerned with proposals to limit these benefits to agency placements only. There are many, many reasons why placements are made outside of agencies, and many legitimate adoptive placements do occur outside of agencies.

Many of our member groups were formed primarily because the efforts of adoptive parents and prospective adoptive parents were well ahead of the work of agencies in identifying and providing homes for children in need of permanency. We do not in any way condone illegal or black-market adoptions, and we certainly do not believe the tax code should do that. But we think the provisions which each bill contains, denying benefits to expenses incurred in violation of State and Federal law, would be sufficient to insure that black market or illegal adoptants are not encouraged.

We also support very strongly the provisions of Senate bill 1479 which would give favorable tax treatment to corporation adoption reimbursement plans. The provisions of that bill provide treatment for adoption reimbursement plans very similar to that given to corporate medical reimbursement plans. And, again, this affirms our belief that adoption is a viable means of building a family, and that public policy should treat adoption expenses in the same manner as the medical expenses of giving birth.

I would like to thank you for the opportunity to provide this testimony, and on behalf of the North American Council on Adoptable Children, thank you very sincerely for your efforts and the efforts of the committee to insure that adoption remains a viable alternative for children in need of permanent, loving homes.

Senator Packwood. Thank you very much.

We will conclude with Mr. Johnson.

STATEMENT OF DOUGLAS JOHNSON, LEGISLATIVE DIRECTOR, NATIONAL RIGHT TO LIFE COMMITTEE, WASHINGTON, D.C.

Mr. Johnson. Mr. Chairman, my name is Douglas Johnson. I am legislative director of the National Right to Life Committee. The National Right to Life Committee is made up of the 50-State right-to-life groups.

On behalf of the committee, I would like to testify briefly in support of the general thrust of all three of the adoption-related bills which are before the committee today.

As you are well aware, nowadays the expenses connected with adopting a child are considerable in almost every case. Adoption of a handicapped child can be particularly expensive and, for many couples, prohibitively so. We believe that a humane society must reject the idea of selectively killing some or all handicapped children before birth or letting them die through deliberate neglect after birth. We also believe that a humane society should seek to assist the many couples who are willing to adopt children who have special needs, but who often find it financially difficult to do so.

The recently enacted Jepsen amendment to the Economic Recovery Tax Act was a good first step toward addressing this problem. We believe that the Jepsen amendment should be viewed, however, only as an initial reform. We support removal of as many financial obstacles to adoption as possible, whether the children involved are infants or older, and whether they are handicapped or not.

It is unjust that current law permits tax deductions for medical expenses connected with childbirth or induced abortion, but allows no deductions for medical expenses connected with adoption. And this very overt and and very unfortunate discrimination should be ended. Beyond this, we believe that all expenses directly connected with a legal adoption procedure—agency fees, legal fees, court costs, and so forth—should be fully deductible. And if a dollar ceiling must be placed upon such deductions, we think it should be high enough to exclude only expenses which are clearly inflated or unreasonable for any legitimate adoption procedure.

Mr. Chairman, to the extent which society facilitates the placement of children in loving families, through its tax laws and through other means, it lessens the temptation for unwed mothers to opt for the violent "quick fix" of abortion. Encouraging adoption also lessens the necessity of placing children in temporary foster care of one type or another, a practice both expensive and, in too many cases, emotionally damaging to the children involved.

Mr. Chairman, we believe that in human terms, and even in dollars, anything which the Federal Government can do to remove financial barriers to adoption will, in the long run, prove to be cost effective.

Thank you.

Senator PACKWOOD. I don't see in your statement any reference to whether or not the adoption expenses should be allowed if it is a private placement as opposed to an agency placement. Do you have any view on it?

Mr. JOHNSON. Mr. Chairman, we believe that these benefits should be applied to direct private adoptions. We share the concern that has been expressed today about the genuine abuses which do occur with regard to black-market adoptions and some of the things that we have all heard about. But we believe that agency adoptions do not necessarily lead to more satisfactory results than private, direct adoptions. There are also many abuses connected with agencies. We would not want to overgeneralize in this area, but there are agencies which are overly rigid, overly bureaucratic, which keep infants, for example, with the birth mothers far longer than is necessary or psychologically helpful either for the mother or the child. And, on the other hand, the great majority we believe of direct adoptions, when performed under State law, do lead to very satisfactory results. And in many cases, this is the only option available to a given young woman in a given situation.

So we would oppose limiting these types of benefits that are being discussed today to only agency placements. However, I think we would concur with Senator Hatfield that we would hope that some middle ground could be found in the State legislatures which would discourage abuses without we hope being overly restrictive in that regard. And we would encourage that the legislation being considered by this committee would accord these types of benefits to all legal adoptions.

Senator PACKWOOD. Mr. McKay, do you think the abuses of private adoptions are so bad and so prevalent that we simply ought to deny a tax benefit for them, period, despite State law?

Mr. MCKAY. Yes, sir. I think that the potential for it is so bad there that it ought to be denied. My point is this, I do not understand why we find it necessary to license groups of people who gather together for a social purpose, a nonprofit social purpose, but we don't find it necessary to license individuals—ministers, doctors, lawyers—who do the same service and provide the same adoption, but don't provide the services of a well-trained adoption worker that go along with it. It is ironic that we have never found it necessary to license individuals that way, but we find it necessary to license groups, such as social agencies.

Senator PACKWOOD. You lost me there. I didn't quite follow your reasoning.

Mr. **McKay**. We find it in our society necessary to license groups of people who gather together for social purposes, but we don't find it necessary to license an individual who does the same thing. And you will find in most States individuals, such as doctors or lawyers or ministers, who perform adoptions, and, are not licensed specifically for child placing. That is where I think the problem comes up. We have no control over them whatsoever.

In many cases, the lawyer who charges for an adoption is putting the fee in his pocket, and the doctor may be doing the same thing—profiteering does not occur always. In fact, it's probably a minority of the cases. But the potential is so bad there that I would prefer to see the people who were going to do adoptions, be licensed by the States.

Senator **Packwood**. Well, let me back up. You said the lawyer who charges for an adoption puts the fee in his pocket.

Mr. **McKay**. That's right.

Senator **Packwood**. What else would he do with the fee?

Mr. **McKay**. He is doing it for a profit. An agency who is providing an adoption service is a nonprofit organization and generally raises a lot of money on the outside to pay for their adoption services in a charitable sense. And I think there is a difference there in potential motivation because I know many individuals that do it with the best thoughts of both parties in mind.

I am talking about the potential damage.

[The prepared statements of the preceding panel follow:]

Prepared Statement of The National Committee for Adoption, Inc.

SUMMARY

The National Committee For Adoption, Inc., testimony is presented by William Pierce. Pierce is President of the national voluntary group made up of agencies and individuals who support adoption.

We thank the Subcommittee for the opportunity to present testimony on legislation which would improve lives for children by making three changes in the tax code. We're especially pleased to endorse the provision making expenses for adoption deductible when arranged through agencies. This not only encourages adoption but encourages the best kind of adoption -- that which is accountable, licensed and professionally sound. We also endorse two other recommendations. Adoption expense benefits which are provided as "fringe benefits" should not be taxable to the employee. Those companies which provide adoption expense benefits should be able to treat those expenses as an ordinary and necessary business expense.

Several Senators deserve special praise for their work on these issues: Senators, Baucus, Bentsen, Cranston, Durenberger, Jepsen, Hatfield, Hawkins, Levin and Metzenbaum. We also thank Chairman Dole for his role in this hearing and Chairman Packwood for his support. Sen. Denton is to be commended for his earlier hearing on adoption, where Sen. Jepsen testified on these issues.

The issue before the Senate is simple. Tax deductions for adoption expenses work. Among the states where the deduction works is Minnesota, a state that also protects all those involved in adoption by requiring all adoptions to be arranged through agencies. Another state that has the tax deduction in its code is California. The California bill was signed into law by then-Governor Reagan. We hope President Reagan will have the opportunity to do for the country what he did for California and that the Congress will present him with an appropriate bill he can sign during 1981.

We're concerned about four items related to adoption. First, no deduction bill should be approved which allows a tax benefit for independent adoption expenses. There are too many tragic cases of human error and greed to make it good public policy to encourage, through the tax code, this risky practice involving helpless children and vulnerable parents.

Second, there should be no artificial limit on the fees which can be deducted. Health, travel and other considerations make such a limit highly impractical. By limiting the deduction to agency-arranged placements, appropriate accountability will be assured.

Third, we commend Sen. Jepsen for his tax credit alternative. This would be a valuable addition to the legislative package we believe most fully reflects our views, S. 1479, Sen. Metzenbaum's proposal.

Finally, we ask that this Committee direct the Treasury to clarify that the recently-enacted $1,500 deduction for adopting "special needs" children includes all such children, not just those determined eligible for adoption assistance payments under Section 473 of the Social Security Act.

My name is William Pierce. I am the President and chief executive officer of the National Committee For Adoption (NCFA).

NCFA is a national, voluntary membership organization for agencies and individuals. NCFA works for infant adoption because we believe it is a positive social institution that builds families, that promotes permanent homes for children and that it is a valuable option for young, single or troubled parents. Supplemental materials about NCFA, detailing our other goals and our services, are attached as part of this statement and we ask that it be made part of the Hearing record.

On behalf of our member agencies, board and other affiliates -- agencies and individuals -- I want to thank you for inviting us to appear at this hearing to consider three bills which would provide for adoption expenses to be given special treatment by the tax code.

We want to first acknowledge the Senators who have devoted their time to promoting tax deductions for adoption expenses during this Congress. Senator Baucus, a member of this Committee, took the initiative early in this legislative session to introduce to his colleagues tax deduction legislation for families who adopt through licensed public or private, non-profit adoption agencies. We endorse his bill, S. 608, and are grateful forSen. Baucus' interest in this tax policy issue. We know that he has contributed substantially to the discussions in the Senate on the careful utilization of the tax code in relationship to the economic conditions of the country.

We owe a great debt of gratitude to Senator Jepsen for his determined advocacy on behalf of adoptive families during the long hours of debate and conference deliberations on the Economic Recovery Act. It was his commitment, supported by Senators Bentsen, Cranston, Durenberger, Hatfield, Hawkins, Levin and Metzenbaum, which we know assured the enactment by the Congress of the first, positive amendment to the tax code for adoptive families: a deduction up to $1,500, for the expenses of an adoption of a child with "special needs." Sen. Jepsen also testified in July before Sen. Denton's Subcommittee on Aging, Family and Human Services, at a hearing on Adoption in the United States, in support of adoption deduction legislation.

Finally, we would like to single out Sen. Jepsen as the one who in a major way is responsible for seeing this hearing held today. His request to Chairman Dole, for a hearing to discuss the adoption deduction proposals more fully, has been honored by Sen. Packwood, Chairman of the Subcommittee on Taxation and Debt Management. We thank you, Chairman Packwood, for calling these hearings.

NCFA ENDORSES S. 1479

We are here today to endorse Sen. Metzenbaum's proposal to amend the tax code to provide adoption benefits to families. S. 1479, a portion of Sen. Metzenbaum's Stronger American Families Act of 1981, has three very positive features which we urge the Senate Finance

Committee to consider carefully, report out, and include as part of any "miscellaneous" tax bills for enactment into law by the 97th Congress. The three provisions would: 1) allow families that adopt to claim the costs of an adoption arranged through a licensed public or private, non-profit adoption agency as a tax deduction (this provision is identical to Sen. Baucus' bill, S. 608); 2) exclude from the income of an employee any "fringe" benefits received from an employer's adoption expenses plan; and 3) treat the employer contribution to adoption expense plans as an ordinary and necessary business expense.

FOUR STATES HAVE TAX DEDUCTIONS FOR ADOPTION

We want to address the matter of tax deductions for adoption expenses first and begin by pointing out that in this area, as is frequently the case, several States have already led the way. Tax deductions are in place and working in at least four states: California, Massachusetts, Minnesota and Wisconsin.

For example, in Minnesota, where adoptions can only be completed through licensed public and private, non-profit agencies, an itemized deduction for adoption expenses has been in effect since 1969. The deduction expense allowance is limited to $1,250. The following information about the use of the deduction during 1978 from a sample of 22,000 Minnesota individual tax returns was prepared by the Department of Revenue:

Deduction for Adoption Expense from a
1978 Sample of Individual Income Tax Returns

Minnesota Gross Income Ranges	Number of Returns Using Adoption Deduction	Amount Claimed for Adoption Deduction	Average Deduction	Revenue Loss
Gross Loss	12	$ 2,842	$ 237	
$ 1 - 9,999	100	7,020	70	$ 407
10,000 - 14,999	402	234,440	583	21,263
15,000 - 19,999	703	176,183	251	20,358
20,000 - 29,999	602	330,056	548	41,370
30,000 - 39,999	201	145,526	724	20,374
40,000 - 49,999	102	30,580	300	3,517
50,000 - 99,000	101	34,332	340	5,214
$100,000 And Over	13	16,233	1,248	2,760
Total	2,236	$977,212	$ 437	$115,262

From these figures and the number of adoptions in Minnesota during 1978, the Department of Revenue estimated an actual loss in State revenues to be approximately $37, per child adopted. Obviously, the provision makes sense from a cost-effective perspective, considering the escalating costs to States and the Federal government alike for foster care for adoptable children.

GOV. REAGAN SIGNED CALIFORNIA'S LAW

The California experience with a tax deduction for adoption expenses is similarly positive. The California Revenue and Taxation Code allows a deduction for the expenses paid or incurred in connection with the adoption of a child, including any medical and hospital expenses of the mother which are related to the child's birth and any welfare agency expenses, which exceed 3% of the adjusted gross income, but the deduction is limited to $1,000. The 3% limitation does not apply to the adoption of special needs children. According to figures provided by the Research Department of the Franchise Tax Board as well as the Adoption Policy Bureau of the Department of Social Services, the use of the deduction over a three-year period, from fiscal years 1978-1980, represented an average deduction of approximately $413 per return. The total cost to California for the tax deduction provision for those three years was approximately $17 per child adopted in the State.

The California Tax Code Amendment was signed into law in 1968 by Governor Ronald Reagan. It is encouraging to us that such an innovative move could be repeated, for the benefit of all American taxpayers who have built their families through adoption, by that same adoptive father, President Ronald Reagan.

ADOPTIONS BY AGENCIES -- IN THE BEST INTERESTS OF THE CHILD

The underlying goals of all of the Federal tax deduction bills under discussion today are similar. They encourage the adoption of hard-to-place children. They prevent unnecessary amounts of time in foster care for children who are free for adoption. They eliminate the inequities of the tax code which treat family formation by childbirth differently than forming a family through adoption. But some of the bills -- S. 1479 and S. 608 -- go one step further. As Congressman Oberstar (D-Minn.) described H.R. 1596 (companion, identical legislation to S. 608) to the House Ways and Means Committee at a hearing on April 1: "The bill" makes the tax incentive one that insures the placement of a child by those who take into consideration the best interests of the child over any other factor."

Congressman Oberstar was, of course, talking about adoption agencies when he described "those who take into consideration the best interests of the child over any other factor." He is aware, as we are, that there are other, powerful factors at work in adoption. We know that there are many loving people who hunger for a child of their own to parent. We know that there are many people who look upon the impoverished child, the orphan in another country and say to themselves -- that child would be better off with me.

But these factors, powerful as they are, good as they are in their intent, are not sufficient to transform good wishes into property rights to a child. Not everyone who wishes to adopt a child meets the generally accepted tests our society agrees to. Among the more subtle questions society asks is: is there a better home for this child than the one that most easily presents itself?

Six States have wisely chosen to protect the best interest of the child over any other factor by prohibiting private, independent placements -- that whole range of practices that range from people "brokering" children like so many pets to outright black-market baby-selling. Those states did so in the full knowledge that there were exceptions, as there always are, to the rule that agencies should arrange adoptions. There are warm, dedicated, honest and well-meaning individuals -- including physicians, lawyers, members of the clergy and others -- who had nothing but the most noble of intentions.

The problem isn't with "direct placements" -- even these six States allow biological parents (usually the mother) to place children for adoption with a step-parent or close relative "directly" with only a legal, court procedure required. Step-parent and relative adoptions are very inexpensive and need not be covered by adoption deduction legislation, in our view. The risks are much smaller in these kinds of adoptions, properly handled, than in independent adoptions.

EXAMPLE: SUPREME COURT UPHOLDS RETURN OF 25-MONTH OLD TO FATHER

An example, which recently came to light and received attention because it went to the Supreme Court, may help illustrate our concern about the risks of independent adoption to all parties -- the baby, the biological parents, and the adoptive parents. The Supreme Court let stand a lower court ruling that granted custody of a 25-month old to his biological father over the objections of the adoptive parents. The ruling, made in February, 1981, in Riggs v. Terrazas found that when a parish priest advised the young, unmarried mother to state that the identity and location of the biological father of her child was "unknown"the parental rights of the father, Mr. Terrazas, had been violated. The priest arranged for a couple in another state to adopt the child. Twenty-five months and approximately $80,000 in legal costs later, the young child was removed from one set of parents and turned over to his biological father. This case, tragically, is just one of many. Others involved well-meaning lawyers and physicians, or well-meaning "neighborly" people. The fact is that there are immense legal, psychological and financial risks -- over and above the human misery -- in placement through well-meaning but unauthorized, unlicensed individuals.

EXAMPLE: 30% OF INDEPENDENT ADOPTIVE HOMES "UNSATISFACTORY"

One of the persuasive arguments made for "Abolishing Baby Buying: Limiting Independent Adoption Placement" was that of the Hon. Alfred L. Podolski, Chief Judge, Probate Courts of the Commonwealth of Massachusetts, in an article of that title. Originally delivered as a speech at the annual meeting of the Family Law Section of the American Bar Association, it was printed in Family Law Quarterly, Fall, 1975, pp. 547-554.

Judge Podolski's careful and persuasive arguments against adoption outside established agencies include:

+ The agencies do not make money from adoptions.
+ They have qualified and motivated staff capable of investiaging proper placement, and they have qualified and responsible management people capable of making responsible decisions in regard to the best interests of the child.

Judge Podolski recognizes that agencies are not perfect. He says "They are frequently under-staffed, definitely underpaid, and often unreasonably regulated. But they do provide a system for adoptions and, because of the state's control, there is a way of improving the system through the technique of licensing and regulation. This aspect of responsibility and control is the distinguishing factor between public and private placements."

Judge Podolski also cites, from a Florida study which favored private placements, the wholly unfavorable statistic that "...almost 30% of the independent adoptive homes were unsatisfactory." There is, of course, no need to have such a high percentage of unsatisfactory homes, as Judge Podolski observed: "If it is true that there is a shortage of adoptable children, we can be thankful there is no shortage of adoptive families. Through agencies they are the subject of what is usually an intensive investigation which many natural parents could not pass -- a screening which provides some real assurance of permanent, satisfactory homes for those too young to care for themselves."

EXAMPLE: A CHURCH'S SUPPORT FOR AGENCY ADOPTIONS

One major church body, The Church of Jesus Christ of Latter-Day Saints, has instructed its Church members and officers to abstain from becoming involved in arranging child placements. Instead, the Church directs its members to rely upon the LDS Social Service agencies which are licensed in the States in which they do adoption and foster care services and which have the specific responsibility for the Church to arrange adoptions. This is a model we would hope more sectarian, fraternal and voluntary associations would use.

A more constructive approach than engaging in the practice of independent adoptions is to work at making agency practices widely available and of uniformly high quality. Our society, mainly through State and local governments, has implemented mandatory licensing of foster homes, day care facilities and other full or part time care available to children and adults unable to live independently. When a lifetime plan is made for a child, it seems reasonable that the "agent" for child placement be one that is knowledgeable, well-trained, and accountable to society. In other words, the "agent" should be the social institution of an agency.

S. 1479 and S. 608 PROMOTE AGENCY ADOPTIONS

Our organization's first priority, stated as Goal #1 of our 1981 Work Goals, is to "Work for elimination of non-agency adoption to insure better protection of infants". We concentrated a major part of this testimony on this area of our work because it relates directly to the provision included in S. 608 and S. 1479 which limits the deduction to families who have adopted though an agency.

We concentrated on this factor because it doesn't make sense to us to spend public tax dollars on a tax benefit that could end up hurting children and families -- and possibly cost more money to provide services to try and heal their hurt. We don't want special needs children adopted by the wrong people -- especially with a tax incentive. We don't want people inappropriately importing babies from other countries -- with a tax break that filters back to the brokers and other profiteers. We don't want unsatisfactory potential parents to be encouraged in their search for a healthy infant, certain that they'll be able to write off whatever they have to pay some intermediary.

That's why we're particularly enthusiastic about S. 1479. This bill provides equity for those couples whose families are built through adoption with those married couples who deduct the medical expenses of having a biological child. The bill provides encouragement to prospective adoptive parents and biological parents who wish to make an adoption plan for their child to choose the best possible way to complete a legal adoption. The best possible way is through a State licensed child placing agency -- a public or private, non-profit adoption agency. The bill is, therefore, not merely a tax relief measure for adoptive parents, important as that incentive is.

SUPPORT FOR SEN. JEPSEN'S "CREDIT" IDEA

Before leaving the tax deduction for adoption feature of these bills, we would like to strongly support the concept, introduced by Sen. Jepsen in S. 1580, of offering the taxpayer the choice of a deduction or a tax credit. We know from other organizations that they, too, support the tax credit approach not just because it would be more useful for couples who do not itemize their income tax but it would also benefit more low-income and modest-income families.

LIMITS ON FEES

It is also important that the Federal government not try to establish artificial limitations on the amount of the adoption expenses which could be deducted. By limiting the deduction to adoptions arranged by agencies, there is a built-in, state monitoring of fees for adoption. This will be an adequate protection against inappropriate fees and deductions for fees. As it is, the average domestic adoption fee in many non-governmentally-supported agencies -- private agencies wholly dependent on voluntary gifts and fees -- is well over $3,500.

TWO OTHER TAX FEATURES

The two other major features of these legislative proposals are also positive. We are pleased to see major corporations including adoption benefit programs as part of their employees' fringe benefit packages. But those adoption benefits, should be treated as non-taxable income. As it is, the real benefit to employees is substantially reduced through taxation.

S. 1479 would also offer an important, additional incentive to employers. We are pleased with the response of business and their presence in this hearing talking about their adoption benefit packages. We join them in asking you to see that, for tax purposes, their contributions to adoption expense plans be treated as an ordinary and necessary expense. NCFA has been working through its network of hundreds of adoptive parents to encourage more employers to establish programs similar to corporations such as Foote, Cone and Belding, Felt Products Manufacturing Company, Smith Kline, International Business Machines Corporation, Hallmark, and Xerox Corporation, to name a few. These changes will make that task easier.

CLARIFICATION OF CURRENT LAW NEEDED

We believe that the tax code can be used positively as a vehicle to reinforce adoption as a positive family-building option. When the new tax law included a provision for the adoption of special needs children we were encouraged. While this provision is limited -- it is a good first step. However, there are many thousands of children with special needs waiting for adoption who have not or won't be determined eligible for adoption assistance payments as specified in Sec. 473 of the Social Security Act (the new provision of P.L. 96-272). We would hope that the Finance Committee and the Senate would see the importance of not limiting the tax deduction only to those children who are already recipients of Federal government funds, but that it would also allow children under the care of the State or voluntary sector who have "special needs" to be adopted with a tax deduction available to their adoptive family.

For example, in the State of Louisiana, only children in the care and custody of the State Agency can be eligible for the adoption subsidy. This means that the children and families served by licensed, voluntary agencies will not be eligible to take a tax deduction for the expenses they incur. We are hopeful that the Treasury will be instructed by the Senate Finance Committee to interpret the enacted tax deduction to include all children who can be defined as "special needs" with or without determination of eligibility for adoption assistance payments.

CONCLUSION

In summary, we want to thank the Subcommittee for holding a hearing on the legislative proposals which have been introduced to amend the tax code for adoptive families' expenses. It has become increasingly evident to us that there is an important need for public information about tax deductions for adoption expenses as well as adoption benefit programs. For example, we have been collecting copies of the various summaries of the Economic Recovery Tax Act of 1981 which have been prepared for major trade and popular publications. None of these summaries mention the tax deduction provision for the adoption of special needs children.

Therefore, we assure you, that as we continue to work to see S. 1479 enacted into law, we also will be promoting the current provision in the tax code, as well as the enactment of State tax deduction provisions and employee benefit programs to lawmakers and newsmakers, alike.

Building families through adoption is too positive of an American social institution to be ignored by the American people for long.

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ATTACHMENTS:
1) 1981 GOALS OF THE NATIONAL COMMITTEE FOR ADOPTION, INC.
2) List of Officers, Board of Directors, and Member Agencies of NCFA
3) Brochure outlining services provided by NCFA as direct benefits of membership

ATTACHMENT 1

1981 GOALS OF THE NATIONAL COMMITTEE FOR ADOPTION, INC.

The National Committee For Adoption will:

1. work for elimination of non-agency adoption to insure better protection for infants
2. make the Federal "Model State Adoption Act" acceptable or stop it and monitor similar activities at the State level
3. set up State-level registries through State legislation supported by State-level Committees affiliated with the National Committee For Adoption
4. link State-level registries through the National Committee rather than through any Federal data bank
5. operate a variety of information services for those interested in infant adoption and related services, especially services to unmarried parents, including
   - a hotline exclusively for the use of supporters
   - newsletters focused on infant adoption and services to unmarried parents
   - bulletins
   - other analyses, manuals, directories and materials
   - discounts on materials, books and other resources published by others
6. defend appropriate adoption practice with the media, lawmakers, policymakers, the human services field and the general public
7. rejuvenate adoption as an option of choice for young, single or troubled parents
8. provide such other services as may be needed, including
   - information about and training needed to help agencies and individuals cope with changes in practice
   - current developments in court cases and legal developments affecting infant adoption and services to unmarried parents
9. review existing research and do new research, as needed, to bolster appropriate agency practice
10. respond, as necessary and appropriate, to any contingency which would affect the field of infant adoption and services to unmarried persons.

ATTACHMENT 2

NATIONAL COMMITTEE FOR ADOPTION
[illegible]
[illegible]
[illegible]
[illegible]

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Richard Stillman, M.D.
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Catholic Charitable Bureau of Boston
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2912 East 7725 South
Salt Lake City, Utah 84121
Telephone: 801/531-3634

Jan Wilkins
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NATIONAL COMMITTEE FOR ADOPTION
[illegible]
[illegible]
[illegible]

MEMBER AGENCIES

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New Orleans, Louisiana 70001
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Jack Bovaird, Associate Director

The Barker Foundation
4545 42nd Street N.W.
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Telephone: (202) 363-7751
Ruth Duh, Executive Director

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Roger Toogood, Executive Director

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Christian Placement Service of New
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Charles Anderson, Supervisor/Adoption

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Jo Ann Caldwell, Executive Director

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Volunteers of America
354 Jordan Street
Shreveport, Louisiana 71101
Telephone: 318/221-2669
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9/84

ATTACHMENT 3

This is YOUR INVITATION to join the NATIONAL COMMITTEE FOR ADOPTION!

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A POSITIVE INSTITUTION
THAT BUILDS FAMILIES

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HOMES FOR CHILDREN

AND THAT IS AN OPTION
FOR UNMARRIED PARENTS BY

- IMPROVING AND EXPANDING SERVICES
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(202) 463-7559

FOR YOU

YOUR AGENCY
OR ORGANIZATION

YOUR COMMUNITY . . .

THE NATIONAL COMMITTEE FOR ADOPTION

- Supports agency adoption to protect children and families
- Supports the right to confidentiality for those in the adoptive circle
- Encourages and serves non-profit agencies that provide infant adoption services and services to unmarried parents
- Provides information about adoption, services to unmarried parents, and infertility
- Works for sound standards of professional practice
- Looks into the impact of current adoption practices on babies, unmarried parents and people who want to adopt
- Develops and works with state committees for adoption
- Educates the general public on the value of agency adoption and services to unmarried parents
- Advocates in Washington, D.C. and in state capitols

DIRECT BENEFITS OF MEMBERSHIP

	AGENCY	CHAIRMAN'S CLUB member	CORPORATE patron	CORPORATE sponsor	CORPORATE regular	INDIVIDUAL sustainer	INDIVIDUAL supporter	INDIVIDUAL regular
Participation in a NCFA council	●	●	●	●	●	●	●	●
Annual Report	●	●	●	●	●	●	●	●
National Adoption Reports (newsletter & bulletins)	●	●	●	●	●	●	●	●
Reduced fees at institutes, forums and the Annual Meeting	●	●	●	●	●	●	●	
Discounts on NCFA publications and visual aids purchased through NCFA's bookstore	40%	40%	40%	40%	20%	10%		
Unmarried Parents Today (newsletter & bulletins)	●	●	●	●	●			
Discounts on non-NCFA publications purchased through NCFA's bookstore	10%	10%	10%	10%				
Free consultation and technical assistance by mail	●	●	●					
Participation in the Chairman's Club briefings	●	●						
Use of NCFA's logo	●							
Right to display certificate of agency membership	●							
Listing in directory of member agencies	●							
Participation in long distance telephone service	●							
Participation in the Conference of Executives	●							
Elect NCFA's Board of Directors	●							

DUES

AGENCY

Annual dues are based upon a flat fee of $1,000 plus an additional fee of $10 per U.S. child under age two placed by the agency or $10 per unmarried parent residing in agency facilities, whichever is greater.

Any licensed not-for-profit voluntary agency interested in infant adoption and related services, especially services to unmarried parents, is eligible for membership.

CORPORATE

Agencies, organizations or firms which are interested in the work of the National Committee For Adoption but which do not qualify for agency membership can also join. These members receive special benefits.

Patron membership annual dues are $5,000 minimum.

Sponsor membership annual dues are $1,000.

Regular membership annual dues are $500.

INDIVIDUAL

For individuals or couples concerned with the issues and goals of the National Committee For Adoption.

Chairman's Club—a special membership category for those who wish to be actively involved with the National Committee For Adoption in leadership activities, in policymaking and informed in detail about developments affecting adoption and related issues.

Lifetime member dues are $5,000 for an individual, $10,000 for a couple (payable one time only).

Regular Chairman's Club member annual dues are $1,000 for an individual, $2,000 for a couple.

Sustainer membership dues are $100 annually for an individual, $200 for a couple.

Supporter membership dues are $50 annually for an individual, $100 for a couple.

Regular membership dues are $25 annually for an individual, $50 for a couple.

--------- **Detach and return this application to: NCFA, Suite 326, 1346 Conn. Ave., N.W., Washington D.C. 20036** ---------

I want to join the National Committee For Adoption and receive all member benefits.* Please enroll me for the membership category below.

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☐ Individual $25
☐ Couple $50

Supporter Annual Dues
☐ Individual $50
☐ Couple $100

Sustainer Annual Dues
☐ Individual $100
☐ Couple $200

Chairman's Club Annual Dues
☐ Individual $1,000
☐ Couple $2,000

Chairman's Club—Lifetime Member
☐ Individual $5,000 (payable one time only)
☐ Couple $10,000 (payable one time only)

*$6 of all dues of $50 or more is allocated to NATIONAL ADOPTION REPORTS

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Corporate Sponsor Member Annual Dues
☐ $1,000

Corporate Patron Membership Annual Dues
☐ $5,000 minimum

Agency Membership
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Please indicate below the one Council in whose election you wish to vote and to be eligible for elective offices. You may choose only one Council even if you are, for example, both an adult adoptee and a lawyer.

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☐ B—Biological Parent
☐ C—Adoptive Parent
☐ D—Adoptive Grandparent
☐ E—Adoptive Relative
☐ F—Other Individual
☐ G—Clergy
☐ H—Educator
☐ I—Home Economist
☐ J—Lawyer
☐ K—Nurse
☐ L—Physician
☐ M—Social Worker

If you wish to be a non-voting member of other Councils list them in the order of your interest.

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OPTIONAL INFORMATION SECTION

____________________ Residence phone
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____________________ Spouse's occupation

Latin America Parents Association
NATIONAL HEADQUARTERS • P.O. BOX 72 • SEAFORD, NEW YORK 11733

SUMMARY
of
Principal Points

(1) Represent Latin America Parents Association, a volunteer, not-for-profit national organization whose members have either adopted or plan to adopt children from Latin America.

(2) Support limited positive action taken by Senate Finance Committee in recognizing the financial burdens of adopting families.

(3) Proposed legislation discriminates against persons who incur adoption expenses through direct or intercountry adoption. These types of adoptions are not addressed.

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Hightstown, N.J. 08520

Maryland Region Chapter
P.O. Box 4403
Silver Spring, MD 20904

Philadelphia Region Chapter
P.O. Box 18107
Philadelphia, PA 19116

Connecticut State Chapter
P.O. Box 8938
New Fairfield, CT 06810

[illegible]

Statement of Patricia O. Buchanan, Latin America Parents Association
before the
Senate Committee on Finance, October 16, 1981

Honorable Senator Dole and distinguished members of the Senate Finance Committee:

My name is Mrs. Pat Buchanan. I am here today to testify and offer comments on Senate Bills S.1580, S.1479, and S.608. I present these comments on behalf of the Latin America Parents Association, a volunteer, not-for-profit national organization whose members have either adopted or plan to adopt children from a Latin American country. Our organization has its headquarters in New York with chapters in Maryland, New Jersey, Connecticut and Pennsylvania. The current membership of about 1,000 families reside in 37 states. I am now and have been the President of the Maryland Region Chapter for five years. Over the years we have watched, supported and been heartened by the attempts and steady progress to have thousands of children in the foster care system released for adoption. We are especially pleased with the recent actions taken by this committee to allow a tax deduction for the adoption of a child who is handicapped, over the age of six, or who is a member of a minority race or ethnic group.

The recognition by this committee of the financial burden on adopting families is a major step forward. However, I hope this committee comes to understand and appreciate that almost all adopting parents, in their attempts to bring children into permanent and love-filled relationships, incur large financial burdens that are in no way reimbursed through medical plans nor are they allowed as tax deductions or tax credits to help defray costs. This committee, by positive action, can help provide some financial relief in this area, but each could be modified to provide greater, equal treatment to all adopting parents. As you might imagine, we see S.1479 and S.608 as falling short in providing relief for all adopting families. The wording in both of these bills would seem to exclude two specific groups who adopt--those completing intercountry adoptions and those that have a child placed with them by the birth mother. All intercountry adoptions, with the possible exception of some children from Korea, depending upon eventual interpretation, (this because many children from Korea are placed through U.S. agencies) would be excluded. These two bills give no consideration whatsoever to the approximately 5,000 children that are placed for adoption here in the United States each year by various public welfare departments or volunteer, not-for-profit orphanages licensed in foreign countries. A viable alternative to birth mothers is to place the baby directly with the adopting parents. S.1479 and S.608 would not allow any financial relief for adopting parents who have a child placed with them in this manner. The attitude in these two bills on this subject of direct placement are: (a) an agency always knows best, and (b) there is something tainted with direct placement. Neither of these attitudes are correct: (a) direct placements work as well as agency placements, and (b) television and newspaper stories notwithstanding, we believe that most direct placements are done in a legal manner. Note: as a method of backing up deductions, adopting parents might be required to produce a copy of the expense affidavit that must be filed in many states at the time they finalize the adoption.

S.608 has an effective date of December 31, 1981, while the other two bills use December 31, 1980. A December 31, 1980 date would offer financial aid to a larger number of adopting parents.

It does not appear to us that the enacement of new tax laws is the place to make social policy on which is the "best" method of adopting. This question has been discussed for years and we do not believe it should be answered here in the tax code.

All reasonable and necessary costs in all adoptions not in violation of either State or Federal laws should be allowable towards a tax deduction or a tax credit. Of the three bills, S.1580 comes closest to fulfilling this type of broad approach. In addition, S.1580 places a cap on the amount of expenses that would be either deductible or tax creditable. The caps appear a little low based upon the experiences of our members. However, they are a good step in offering some relief to adopting parents while at the same time limiting budgetary exposure in these difficult times.

All three bills appropriately provide for the denial of double benefits. However, only S.1479 goes one step further and attempts to encourage the private sector employer by excluding from the income of an employee any benefit received from any contribution of an employer to an adoption expense plan. Reimbursement of expenses from such a plan would not be a deductible expense. Since only 5,000 international adoptions occur each year, the revenue loss would not exceed $3 million per year.

I fail to see the difference between a needy child in India that is sent to an American family by Mother Theresa and a child that happens to be born in America. While I agree that we have a special responsibility to American-born children, we must remember that existing law, agency practices and a typical more than three-year waiting list for U.S. children make international adoption a last resort for most families. The motto of Holt International puts it very well, "Every child of whatever nation or race has the right to grow up with parents of his own. A silent call of homeless children is to all men of good will to see that neither apathy nor prejudice, neither custom nor geographic boundary, shall prevent these children from receiving this God-given right."

The attached statistics, obtained from official Immigration and Naturalization Service records, show the number of intercountry adoptions from 1969 through 1979. These figures support our recommendation that expenses incurred through intercountry and direct adoptions be included.

Encl.

TESTIMONY OF PAUL BANKERD, A MEMBER OF THE NORTH AMERICAN COUNCIL ON ADOPTABLE CHILDREN, BEFORE THE SENATE COMMITTEE ON FINANCE, OCTOBER 16, 1981.

My name is Paul Bankerd, and I am pleased to have been invited to present testimony today before the committee on behalf of the North American Council on Adoptable Children (NACAC). The Chairman and members of this Committee are to be commended for the wisdom and timeliness of their decision to hold hearings on these legislative proposals concerning adoption expenses and tax deductions and credits. During this difficult financial period, it is indeed appropriate that those who seek to provide a stable family structure to our nation's most vulnerable children be afforded the kind of tax relief that aids their efforts.

For many years, I have been an active member of the North American Council on Adoptable Children, and its local affiliate, the Council on Adoptable Children (COAC) of metropolitan, Washington, DC. Our organization is a broad-based citizen coalition whose primary goal is to help children find permanent loving families. We have over 480 local chapters all across the United States, with a combined membership of nearly 20,000. From the beginning of our existence we have focused our concern on the needs of children who wait for an adoptive family. All of our members believe deeply that every child who needs a family can and should find one. We have come to this commitment largely because of our personal experience in building our families through adoption. I am an adoptive parent: two of our three children were added to our family through adoption. I am also a current memeber and former chairman of the city of Alexandria, Virginia's Social Services Advisory Board, and in my professional life, I am a management expert and income tax consultant, all of which makes keen my personal and professional interest in this legislation.

The North American Council on Adoptable Children applauds the Chairman's efforts to hold these hearings, as well as the efforts os those Senators who have sponsored these legislative proposals to expand upon the adoption expense deduction incorporated into the Economic Recovery Act of 1981. At the time of the Act's passage, though we were gratified to see this issue being addressed, we were concerned with the eligibility requirements of that law. Because those requirements are dependent upon benefits received under other legislation, a family's ability to participate in this tax relief could be limited due to future changes in appropriations or amendments to the funding measure unrelated to the tax law, or by a restrictive interpretation from the Internal Revenue Service. I am certain that the Chairman and his colleagues are very much aware of the great possibility of either occurrence.

All of the current proposals discussed in these hearings would serve to clarify the adoption deduction provisions of the Economic Recovery Act of 1981, and would go beyond those provisions by recognizing that adoption is a viable means of building families, not only for children with special needs, but for all children in need of permanent homes. America draws much of its creativity and strength from its respect for and support of the family. As a nation, we must take steps to insure the inclusion of all of our country's children in this rich heritage. As an adoptive parent, I have found adoption to be a wonderful method of adding children to my family; every bit as marvelous and awe inspring as the process of child-birth. I believe it is entirely appropriate that the legal and administrative expenses required for the adoption process be accorded the same tax benefits as the medical expenses involved in adding children through giving birth.

As an national organization with active communication with its grass-roots memberships, we are concerned, however, with proposals to limit this deduction only to agency placements. We strongly and whole-heartedly agree that our nation's tax law and public policy must in no way support, condone, or encourage illegal or "black-market" adoptions. Yet this proposal seems unnecessarily restrictive. There are many instances of legitimate placements made outside of agencies. Many of NACAC's member groups were formed primarily to support adoptive parents and prospective adoptive parents whose own efforts were well ahead of established agencies in identifying and providing homes for children in need of permanency. We believe that if an adoption is entered into legally, it should not be denied the full benefits of the law. Thus, provisions denying the deduction to expenses "incurred in violation of State or Federal law" adequately eliminate the possibility that this deduction could be used to benefit illegal adoptions.

As an organization which has been closely following and encouraging the development of corporate adoption reimbursement plans, we strongly support the provisions of S.1479 which provide for tax deductability of these plans similar to that provided for corporate medical reimbursement plans. Again, this approach affirms our belief that adoption is and should be a viable alternative for adding to families, and that public policy should treat expenses involved in the adoption process in the same manner as it treats expenses of giving birth. These provisions provide federal incentive to our nation's corporate industry to join in this building up of America's family tradition. It invites their participation in these efforts to insure a loving home for all our our country's children.

In closing, on behalf of North American Council on Adoptable Children, I again express my gratitude for the opportunity to present testimony today on these legislative measures which will significantly improve the federal responsiveness to our nation's adoptive families that was initiated by the Economic Recovery Act of 1981. We commend the members of the Committee and you, Mr. Chairman, for the leadership you have shown in creating this opportunity to enlarge upon our nation's rich heritage of family life and we stand ready to help the Congress in its continuing effort to insure that adoption remains a viable alternative for the many children in this country in need of permanent, loving homes.

Submitted by: Paul Bankerd
North American Council on Adoptable Children, Inc.

PREPARED STATEMENT OF DOUGLAS JOHNSON, LEGISLATIVE DIRECTOR, NATIONAL RIGHT TO LIFE COMMITTEE

Mister Chairman, honorable members of the committee, my name is Douglas Johnson. I am Legislative Director of the National Right to Life Committee. The National Right to Life Committee is made up of the 50 state right-to-life groups.

On behalf of the Committee, I would like to testify briefly in support of the general thrust of all three of the adoption-related bills which are before the committee today (S.608, S.1479, and S.1580).

As you know, nowadays the expenses connected with adopting a child are considerable in almost every case. Adoption of a handicapped child can be particularly expensive--for many couples, prohibitively so. A humane society must reject the idea of selectively killing some or all handicapped children before birth, but a humane society should also seek to assist the many couples who are willing to adopt children who have special needs, but who may find it financially difficult to do so.

The recently enacted Jepsen Amendment to the Economic Recovery Tax Act of 1981 (H.R.4242) was a good first step towards addressing this problem. As you know, the Jepsen Amendment permits a $1500 deduction for adoption of a child designated by a state as having certain "special needs" which make him or her difficult to place.

The Jepsen Amendment should be viewed, however, only as an initial reform. We support removal of as many financial obstacles to adoption as possible, whether the children involved are infants or older, and whether they are handicapped or not.

It is unjust that current law permits tax deductions for medical expenses connected with childbirth or induced abortion, but allows no such deductions for medical expenses connected with adoption. This unfortunate descrimination should be ended.

Beyond this, we believe that all expenses directly related to the adoption procedure--agency fees, legal fees, court costs, and so forth--should be fully deductible. If a dollar ceiling is placed upon such deductions, it should be high enough to exclude only expenses which are clearly inflated or unreasonable for any legitimate adoption procedure.

To the extent which society facilitates the placement of children in loving families, through its tax laws and through other means, it lessens the temptation for unwed mothers to opt for the violent "quick fix" of abortion. Encouraging adoption also lessens the necessity of placing children in temporary foster care of one type or another--a practice both expensive and, in too many cases, emotionally damaging to the children involved.

We believe that in human terms--and even in dollars--anything which the federal government can do to remove financial barriers to adoption will in the long run prove to be cost effective.

Thank you.

Senator PACKWOOD. Thank you very much for the panel. I appreciate you taking the time.

We will conclude on this subject with a panel consisting of Robert Bogart and Susan Koralik. Mr. Bogart, go right ahead.

STATEMENT OF ROBERT BOGART, MANAGING DIRECTOR OF CORPORATE HUMAN RESOURCES, AMERICAN CAN CO., GREENWICH, CONN.

Mr. BOGART. Thank you, Mr. Chairman. My name is Robert B. Bogart, managing director of Corporate Human Resources, at American Can Co. in Greenwich, Conn.

I am pleased to be here today to testify on behalf of American Can Co. to strongly support and endorse the tax bill introduced by Senator Metzenbaum, S. 1479, which would exclude from income certain adoption benefits paid by an employer such as American Can as well as provide deductions for certain adoption expenses paid by the individual.

We at American Can Co. consider ourselves a leader in the benefits area, having long recognized the importance of benefits to our employees which are valued today at approximately 40 percent of their pay. We pioneered the concept of flexible benefits to aid, value and help our employees meet specific needs. This program has been in effect since 1979.

Senator PACKWOOD. Let me ask you a question about that.

Mr. BOGART. Yes, sir.

Senator PACKWOOD. When you offer this cafeteria plan, is it a mix of benefits some of which are tax free and some of which are not?

Mr. BOGART. Right now the way our plan is set up we have on the plan all nontaxable benefits.

Senator PACKWOOD. All right. Thank you. Then how are you able to offer this adoption benefit plan, which at the moment is not tax free as a fringe benefit?

Mr. BOGART. Well, what we would do is we would have it as part of our core benefit program, but the employees would have to pay an imputed income on it.

Senator PACKWOOD. All right. Thank you.

Mr. BOGART. Which is what we are supporting, that we eliminate that.

Senator PACKWOOD. And are all of your other flexible plan offerings tax free fringe benefits, or do you have some other that have imputed income?

Mr. BOGART. In the life insurance area, over a certain amount.

Senator PACKWOOD. Over $50,000.

Mr. BOGART. That is correct, except where we use age related rates.

Senator PACKWOOD. Right. Thank you.

Mr. BOGART. In 1982, we added an adoption benefit program. The medical plans have always covered the cost of having a child, but only as a natural childbirth. This disparity in benefits to our employees is why we began studying and implementing an adoption benefit program.

There are other good reasons for our program. When we look at the human side, we see over 60,000 homeless children under the age of 17. At a cost of $2,500 per child, up to $25,000 per child, even on the low end of this cost, it represents over $150 million to society to care for these children. Although it costs $70,000 as an estimate to raise a child from birth to age 17, the North American Council on Adoptable Children, in Washington, informed us that many people that want to adopt a child find that the initial cost is what is difficult to overcome; the ongoing cost of raising a child they can handle.

Our benefit, which will be effective January 1, 1982, will pay $2,000 per adoption of a child under 18 to cover legal fees, court fees, medical costs, and any agency cost. This bill will enable our employees to derive the full benefit of that $2,000, thus making the program more valuable to them by not having them to pay taxes on that amount. The bill will also, in my opinion, encourage other companies to implement adoption programs which are socially responsible programs so that I think industry could start to make more of an impact on this area.

Present law does discourage these programs because of the added cost for social security taxes and the extra paperwork involved, as well as the communications to the employees.

Apparently, it seems that to subject adoption benefits to income taxes unfairly penalizes people who are merely trying to create loving families and, therefore, we strongly urge that adoption payments as a benefit to employees be treated exactly the same way benefit plans made on behalf of natural childbirth are treated by our various employee choice medical plans currently.

Thank you, Mr. Chairman, for allowing me this opportunity to appear here today.

Senator Packwood. Mr. Bogart, thank you.

Miss Koralik.

STATEMENT OF MISS SUSAN KORALIK, PARTNER, HEWITT ASSOCIATES, CONSULTANTS, NEW YORK, N.Y.

Miss Koralik. Good morning, Mr. Chairman. My name is Susan Koralik. I am a partner and consultant with Hewitt Associates, a firm of independent consultants and actuaries in the area of compensation and employee benefits.

Recently we have worked with a number of companies interested in adoption benefits, and today I would like to share some of our thoughts with you based on our experience.

Adoption benefits are offered by a small but growing number of companies. In the summer of 1980, Hewitt Associates talked with 14 companies offering some type of benefit to adoptive parents. Since then, we have talked with a number of companies who have recently established an adoption benefit program or who are now considering such a program. Hewitt Associates started its own adoption benefit plan in April of 1981.

Most of the companies we have talked with decided to add an adoption benefit to their benefits package because they feel it is only fair to offset some of the costs of adoption. When an employee has a child naturally, the company's medical plan covers doctor bills and the hospital expenses. Adoptive parents typically have no benefits, but they may have large expenses often greater than if they had the child naturally.

Among the existing plans we have seen three basic approaches. The first type usually provides reimbursement for specific expenses that adoptive parents incur, such as public or private agency fees, court and legal fees. Other fees might be covered, such as foreign adoption fees, medical examination costs, and pregnancy expenses for the natural mother. Among companies we talked with, the maximum reimbursement varied from $300 up to $2,200 and was usually around $1,000.

As a second approach, some companies provide a set allowance for an adoption. An employee receives a lump sum, regardless of the specific costs involved. In our study, this ranged from $75 up to $1,000.

In the third type of plan, the company provides for the medical costs related to the adoption process through the company medical insurance plan. No legal or court costs or associated costs are covered.

One problem that the companies have cited with the experience in adoption benefits is the taxation of the benefit awards. It is hard to explain to an employee that adoption benefits are considered taxable income. An employee is often unpleasantly surprised to find out that his or her $1,000 benefit is reduced substantially by taxes.

We feel that all adoption expenses provided under a nondiscriminatory plan, should be excludable from the employee's taxable gross income. We see three reasons for making the change.

First, the equity issue. A parent having a natural child is able to receive medical benefits that are not part of his or her taxable income. In a similar way, we should encourage parents who want to have a child through adoption and extend special tax treatment for the expenses of adopting the child.

Second, interest in family related benefits paid by the employer is growing. Employers are much more interested in child care because of the provision in the Economic Recovery Tax Act of 1981 which allows employer payments toward dependent care to be excluded from the employee's taxable income. We feel that if adoption benefits receive similar tax treatment, similar employer interest would be generated.

And, finally, if adoption benefits are nontaxable, we see even greater numbers of employers making this benefit available as another option under flexible benefit programs. One reason some employers have not considered an adoption benefit plan is that it only affects a small number of employees. But a flexible benefit program gives an employee the ability to choose the benefit coverage which best suits his or her needs. With a flexible program, an employee that needs an adoption benefit could choose it from several nontaxable choices. Our experience has shown that interest in the idea of flexible compensation is growing.

Hewitt Associates is now working with over 70 companies who are looking at flexible compensation programs as the only practical way to meet the varying needs of the diverse work force of the eighties.

In summary, Hewitt Associates supports the idea of providing nontaxable adoption benefits. Thank you.

Senator PACKWOOD. Mr. Bogart, does your company provide adoption benefits, whether or not it is a public or a private placement?

Mr. BOGART. Yes, they will.

Senator PACKWOOD. And let me ask you if I might, in your experience as a consultant, most companies, if they do provide adoption benefits, provide them rather as a public or a private placement?

Miss KORALIK. Yes, they do.

Senator PACKWOOD. In your statement you made reference to the day care provision, tax free fringe benefit provision was passed last year. And it was an interesting provision because it provides not only for employer-provided day care but employer paid for day care even off the premises. And you have indicated a growing interest in it. Could you elaborate a little bit on that? It is a particular provision I was interested in.

Miss KORALIK. Yes. Where we have seen the interest is in the flexible concept of giving an employee a choice. We are working with one large employer now who currently employs a large percentage of second wage earners. These people are mostly women whose husbands can cover them under their medical plans with their own employers. So this organization is now looking at the alternative of giving the people a choice of either having medical benefits provided through their organization or, in lieu of medical benefits, taking a similar amount, which is currently running about $1,500 for a family, and paying that instead for day care benefits.

Senator PACKWOOD. And you have run into no problems so far, or have you run into much interest in employers paying for day care off premise? A parent leaves this child at the local B'nai B'rith day care center or the local CYO day care center, and the employer can pay directly to that center if they choose to. Have you run into any of this?

Miss KORALIK. That approach is more common.

Senator PACKWOOD. What approach?

Miss KORALIK. The approach of having off premises, so that the employer is not offering the day care center itself, but just paying the expense to whatever day care center the individual is using.

Senator PACKWOOD. And which one did you say is more common?

Miss KORALIK. That one is more common.

Senator PACKWOOD. That one is more common?

Miss KORALIK. Yes.

Senator PACKWOOD. I would assume so for most smaller employers. It just does not make sense for them to have an on premise day care center.

Miss KORALIK. Yes.

Mr. BOGART. Mr. Chairman, I could elaborate on it. We, at American Can, did look at a non-premise center and there is a lot of complications and legal risks that you have to encourage the company to set one up for very little usage. So we are now piling a program with an agency in White Plains to have an off campus one. So that is the way to go. And what we are trying to do is see where to meet specific needs of our employees the idea over time is to get them to trade off some other benefits to be able to meet their needs, because the cost of a lot of these programs, as you want to do more for the employees, it still does incur a lot of cost for the company.

Senator PACKWOOD. There is no question that day care widely expanded is a costly benefit.

Mr. BOGART. Yes.

Senator PACKWOOD. I am sure it varies between New York City and Newport, Oreg. But I don't know of any place where reasonable day care cost is very inexpensive.

I would appreciate it if you would do a little followup and send me some information about how it is working on this off premises center. That is the conclusion I came to after testimony that most parents would rather leave their child if they could with some neighborhood center where the children would be with people they will be with on the weekend, rather than carting them across town to the work premises.

Mr. BOGART. That's correct. In our study, we did a survey of our employees and found that exactly right. People do not want to bring their children to the work site or somewhere close to the work site, but in certain cases where you don't have that choice, you don't have a neighbor or a grandmother or something like that, then it is a necessity.

Senator PACKWOOD. If you could send me some further detailed information on that I would appreciate it.

Mr. BOGART. I would be glad to do that, Senator.

American Can Company

Robert B. Bogart
Managing Director
Corporate Human Resources

American Lane
Greenwich, Connecticut 06830
203-552-4322

November 9, 1981

The Honorable Robert Packwood
1312 DSOB
Washington, D.C. 20510

RE: American Can Company - Day Care Benefits and Flexible Benefits

Dear Senator Packwood:

It was indeed a pleasure meeting you and testifying at the October 16th hearing you chaired of the Senate Finance Subcommittee on Taxation. I appreciated the opportunity to support the tax bill on adoption benefits introduced by Senator Metzenbaum (S. 1479). After my testimony we discussed day care benefits and I mentioned we had done considerable work in that area. You expressed an interest in day care benefits and requested I send you the material I have. This letter and the attachment are in response to your request. Please excuse the slight delay which is due to the fact I was out of the office for two weeks after October 16th.

At American Can we have actively investigated the area of Day Care coverage since early 1978. Our interests were two-fold:

- What business opportunity was offered due to the changing family structure and the growing need for Day Care; and
- How could ACC provide its employees with a meaningful Day Care Benefit.

At the present time we are planning to implement a Day Care Benefit for our employees effective January 1, 1983, as an option under our Flexible Benefits Program. It will be possible for the company to offer this expensive benefit because of the tax treatment of child care benefits resulting from recent changes in the tax law. Under our Flexible Benefits Program, employees will be able to direct company money to pay for Day Care as a trade off to other benefits without incurring imputed income.

I thought it would be helpful to take you through the entire evolution of Day Care at American Can.

Day Care as a Business Opportunity

In early 1978 a Day Care Task Force evaluated the possibility of American Can Company's establishing a Day Care business. (The detailed results of this study are found in the attached Task Force Report.) The Task Force identified three problems of sufficient magnitude that they recommended against pursuing Day Care as a business opportunity at that time:

2

1. High capital investment required to set up a Day Care facility:
    - To construct a building - $235,000 - $360,000
    - To renovate a building - $ 85,000 - $160,000
2. High ongoing cost to the client company for a quality benefit affecting few employees:
    - Based on five groups of children - $150,000 - $200,000
    - Cost/Child/Week - based on operating expenses only ($166,920) and assuming full enrollment of 50 for 52 weeks/year - $64.20.
3. Uncertainty of being able to achieve full enrollment (50 children at the facility) year after year.

The Task Force did, however, recommend that Human Resources consider Day Care as a benefit to employees because:

1. If a Day Care Center was successfully established, American Can could use its results and the experience gained to re-evaluate the business potential.
2. If the need for Day Care at American Can was not found to exist or a center could not be justified due to little employee support, these results would further support the recommendation that the company not enter the Day Care business.

Day Care as an Employee Benefit - Corporate Day Care Center at Corporate Headquarters

Based on the Task Force's recommendations that American Can consider establishing a Day Care Center as an employee benefit, we conducted a survey to ascertain employee attitudes towards and interest in corporate Day Care. A telephone survey of Headquarters employees having children age 6 or under, was designed by Peter Honig Associates, Inc.

To mask our interest in Day Care, the survey also covered employee's rating of the American Can Benefit Program and their opinions on an automotive service center and/or company sponsored store at Headquarters. Overall employee reaction to Day Care was favorable, as the results below indicate:

Attitude Towards Corporate Day Care Center	Employees with Eligible Children	Employees without Eligible Children	Combined Employee Response
Excellent	34%	30%	32%
Very Good	25	18	21
Good	29	20	23
Fair	6	13	10
Poor	7	17	13
Number Surveyed	151	259	410

However, when asked if they would, in fact, use a company sponsored Day Care Center only 7% of the employees with eligible children said that they would definitely use such a facility, while an additional 13% said that they would probably use such a center.

The main reasons for lack of interest in using a Day Care Center were that the majority of eligible employees were men whose wives were at home with the children (47%) or that their children were already enrolled in nursery school (21%). An additional 11% indicated that the trip to Headquarters was just too long for their children.

Based on this response, we estimated that between 30-35 children were likely to use a Corporate Day Care Center. Since we had identified 50 children as the minimum number needed in order to efficiently operate a Day Care Center, Human Resources recommended against pursuing the matter further at that time.

An additional factor that contributed to that recommendation was the fact that several employees who did not have eligible children complained that a Day Care Benefit would be unfair - resulting in preferential treatment for employees with young children. Since this was before the introduction of our Flexible Benefits Program, these employees had a valid point.

Although we decided not to implement a Day Care Benefit in 1978, we did not lose interest in such a benefit. We kept abreast of developments in this area and became actively involved with the Child Care Council of Greenwich.

In addition, we have recently made a $3,000 contribution to a newly opened Day Care Center in White Plains, N.Y. Our Director of Salaried Benefits is an ex-officio member of this Day Care Center's Board of Directors, which will provide us with actual "hands on" experience with Day Care Centers.

Other Companies' Experience

In 1978 and again in 1981 we contacted several companies that had implemented on-site Day Care programs for their employees. Several of these companies reported that their experiments in Day Care had been unsuccessful. Among these firms were:

KLH
Skyland Textile
Tyson Food
Cincor

The successful Day Care programs were all subsidized by the sponsoring company, and for the most part, involved employee populations that were centrally located within a short commute from the worksite. A summary of our findings follows:

Company	Employees Only ?	Number of Children Enrolled	Waiting List	Max. Charge Per Child
Corning	No	24	Yes	$38/wk.
Forney Engineering	No	63	Long	$28/wk. - EEs 35/wk. - Outside
Official Airlines Guide*	Yes	20	No	$40/wk. now - will be $60/wk. (infants)
PCA	Yes	180	?	?
Stride-Rite	No	50	10	$25/wk.
Wang	No	65	35	$25/wk. - EEs 50/wk. - Outside

*Official Airlines Guide's Center opened 1/5/81. Expect 24 by February, capacity (35) in April.

In the cases of Stride-Rite and PCA, the Day Care Centers were not only successful, but were growing, as can be seen below:

	Number of Children Enrolled	
	1978	1981
Stride-Rite	45	50*
PCA	141	180

*Stride-Rite is licensed for 60, but the director allows only 50. Average attendance at Stride-Rite is 47.

The Future of Day Care as an Employee Benefit

There is a clear need for business to become actively involved in Day Care:

- More than 50% of all women are now working - comprising almost half the adult labor force;
- Fewer than 10% of American families are now comprised of a working father, a homemaking mother and two or more children;
- Over 40% of all families now consist of a working couple;
- Over 17% of all families are maintained solely by a mother;
- Divorce rates have skyrocketed, and over 50% of all divorces still involve young children.

In 1975 there were more than 3.4 million children in some form of Day Care of a full time basis (i.e., 30 hours or more per week); another 2.8 million were in part time care (i.e., 10-29 hours per week); and another 16.7 million received occasional care (i.e., less than 10 hours per week). In other words, almost 25 million children were involved in some sort of Day Care. More than half of the children in Day Care are under six years of age, and of these, approximately 70% are under three. Without adequate Day Care facilities, therefore, many women would find it impossible to continue working, resulting in the loss of trained workers, the disruption of family life, and further strain on an already sagging economy.

However, Day Care is expensive. Government subsidized Day Care slots range from $25 to $40 per week, while private facilities are usually more expensive. (Note: The Day Care Center we have contributed to has weekly fees that range from $55 to $105, depending upon total family income.) While the need for Day Care assistance is obvious, there have been sizable obstacles facing companies wishing to provide such a benefit. First are all the problems I have so far described if a company wants to operate its own facility. Even if cost were not a consideration, the operation of a central facility does not make sense for companies with a widely dispersed labor force. Second, employees without eligible children may resent the "special" treatment being given to employees with eligible children, resulting in reduced morale and even possible hostility towards this benefit and the company. Finally, benefits paid to employees for Day Care have, historically, represented taxable income to the employee.

We are convinced that the first problem is insurmountable for most large companies. It is impossible to staff Day Care Centers at each of over 100 operating plant and office locations. Even if such a move were possible, employees often reside throughout a broad geographic area, frequently at a sizable distance from their worksite. At our Greenwich Headquarters, for example, employees live in Connecticut, New York and New Jersey and many commute from as far away as Danbury. The other two problems can now be easily overcome. The Economic Recovery Tax Act of 1981 established a new non-taxable employee benefit: "Dependent Care Assistance". This legislation, effective January 1, 1982, permits an employer to provide payment for Day Care which will not be includable in the employee's gross taxable income. Because of this favorable tax treatment, we are actively developing a Day Care Benefit for salaried employees of American Can, which we hope to introduce by 1983, as I mentioned earlier.

Due to the nature of our Flexible Benefit Program, we avoid entirely the perception by one group of employees that any other group is receiving special treatment. Under our program, each employee starts out with a predetermined amount of Flexible Credits (i.e., company provided money) which can be used to purchase whatever benefits he/she needs or wants. Employees can allocate "credits" for such benefits as:

Medical Coverage
Dental Coverage
Vacation
Disability Insurance
Capital Accumulation/Retirement

Not only do our employees have a choice between the broad categories of coverage, but they have choices within each category. We offer employees a choice of at least five basic health plans, for example, and where available, these choices are further expanded by local HMO options. Adding a Day Care benefit will not change the way any employee is treated, but it will provide a greater range of choice to every employee as to where to spend his/her benefit dollars and it will be a very valuable benefit to those employees who because of their personal situation have a need for Day Care services.

We are currently investigating the possibility of providing employees with a "Flexible Salary". Under such an arrangement, an employee would be able to use a predetermined portion of his/her salary to pay for benefits in excess of the company provided credits. If this program is implemented, employees will have a much greater choice in the design of individual benefit plans and have the opportunity to trade off a portion of their base salary for benefits which can also be very tax effective. We believe that greater choice is a worthwhile goal for several reasons:

- Employees can have the benefits they actually want - after all, we don't tell employees how to spend their salary, why should we tell them what benefits to take;

- A Flexible Benefits Program is cost effective - competition between benefit options is encouraged and employees become cost conscious. We have found, for example, that when given a choice, the majority of our employees do not select the most expensive health care plan. Instead, they choose plans which require a greater degree of "self-insuring" on their part so that they can "buy" other benefits which they need or want;

- It allows the company to offer benefits that are significant to only a small part of the workforce - such as Day Care - without fearing employee resentment or hostility and significant added costs to the company.

I hope this letter and the attached report provide you with information which will be useful to you. I am also sending you an employee booklet and a newsletter about American Can's innovative Flexible Benefits Program. If I can provide you with any further information on our Program, our Adoption Benefit, or the benefit we are developing to provide Day Care assistance, please do not hesitate to contact me. We are, of course, appreciative of all legislation which will allow progressive benefit programs such as our Flexible Benefits Program and we look forward to further favorable legislation in the cafeteria benefit area. Thank you for taking the time to review this material and gain a better understanding of employee benefits. It is only through the interest and actions of legislators as yourself and Senator Metzenbaum that progress keeps getting made in this important area.

Sincerely,

Bob Bogart

Robert B. Bogart

RBB/saf
Attachments

cc: Senator Metzenbaum

bcc: S. J. Giudice
W. J. Carlin
M. J. Scott
J. A. Haslinger
R. H. Felder
P. F. Van Keuren
R. P. Swigart
E. D. Kratovil

Senator PACKWOOD. Now, let me ask you, are either one of you familiar with any other companies that provide auto care benefits?

Miss KORALIK. No, I am not.

Mr. BOGART. I could elaborate on that for a second.

Senator PACKWOOD. All right. [Laughter.]

Go ahead.

Mr. BOGART. We at one time did look at it. We have an underground garage at our facility at American Can Co., and we did look at the possibility of having you leave your car there and somebody would come in and pick it up. But there seemed to be, again, there was a certain code problem, building code and all kinds. We wanted to set up a garage to get the tires changed and all that. But there seems to be that the Government and State agencies and everything else threw up more road blocks than it was worth. That is usually the problem.

Senator PACKWOOD. That is interesting. With this other company that provided it, they never mentioned that. And they simply went to it from a cost standpoint. They were a large suburban company in an area with no good mass transit and no nearby car repair facilities. And they did it from strictly a self-interest standpoint. They say it has worked out very, very well and, from the employees' standpoint, very satisfactorily. But they never mentioned any of these roadblocks. But it is a different State from New York.

Mr. BOGART. Right. As a matter of fact, you didn't want to mention the name before, but I would be interested if you could send me the name of that company. I would like to contact them and talk to them about it.

Senator PACKWOOD. Talk to me afterwards and I will tell you who it is. I just don't want the IRS to find out yet.

Mr. BOGART. Thank you. [Laughter.]

[The prepared statements of the preceding panel follows:]

COMMITTEE ON FINANCE
UNITED STATES SENATE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

Written Statement By:

Robert B. Bogart
Managing Director, Corporate Human Resources
American Can Company
American Lane
Greenwich, Connecticut 06850

October 16, 1981

SUBJECT OF STATEMENT: S.1479 INTRODUCED BY SENATOR METZENBAUM ON ADOPTION BENEFITS

For many reasons, American Can Company strongly supports the tax bill introduced by Senator Metzenbaum (S.1479) which would exclude from income certain adoption expenses paid by an employer, as well as provide a deduction for certain adoption expenses paid by an individual.

At American Can, as is the case at other corporations, benefits are an important part of our employees' total compensation. Today the average employee's total benefit package is worth approximately 40% of his or her pay. At American Can, we have long recognized the importance of employee benefit programs. Several years ago, the management of American Can concluded that the traditional approach to employee benefits was not adequate to meet the diverse and ever-changing needs of an increasingly complex workforce. Because of this, we pioneered the concept of Flexible Benefits, thereby enabling our employees to select those benefits which they truly need. This program has been in effect for all of our salaried employees since 1979.

In 1982 we are further attempting to meet the new and non traditional needs of our employees by offering a Financial Planning benefit and by instituting, as part of our CORE coverage, an Adoption Benefit. For years major benefit plans have covered all, or most, of the costs associated with having a child - but only if the mother physically gave birth to that child. In those cases where the parent or parents either could not have a child naturally, or chose not to do so, whether for medical, religious or other reasons, but still wanted a child, the traditional benefit plan offered no assistance. These parents were faced with two alternatives: either forgo having a child at all, or personally incur a substantial expense in order to adopt a child.

This disparity in the way that our benefit plans covered our employees was the initial reason we began studying the possibility of implementing an adoption benefit. However, as our research progressed, another good reason emerged for providing a benefit of this type. Simply put, it is estimated that there are more than 150,000 homeless children in the United States today who are eligible for either adoption or foster homes. While accurate statistics are not available, our best estimate is that almost 2 to 3% of all children in the U.S. age 17 and younger are currently without a home. Even if this estimate is inaccurate and only 1% of children under 17 fall into this category, we are still talking about more than 60,000 children. The human problem is only part of this story. The Adoption Resource Center in Boston, Mass., estimates that the annual cost to care for these children in public and private institutions ranges from a low of $2,500 per child to a high of $25,000. At the minimum, then, the annual cost to society to care for these children is in excess of $150 million.

We haven't deluded ourselves into thinking that a single company's Adoption Benefit - or for that matter even many companies' programs - will solve this problem. Raising children is a tough, demanding and expensive task, and a benefit which pays up to $2,000 toward the expenses of an adoption is minimal with respect to the other expenses associated with children. Just last December, for example, U. S. News & World Report estimated that it cost $70,000 to raise one child from birth through age 17.. However, such a benefit may make some difference. Ms. Laurie Flynn, of the North American Council on Adoptable Children in Washington, D. C., informed us that many people who want to adopt a child find the initial cost a difficult or even an impossible barrier to surmount, although they can afford the ongoing expenses.

Our benefit is not intended to solve a social problem of this magnitude. However, as a leader in industry in the area of employee benefit plans, we are hopeful that more companies will join us and the few other major corporations providing adoption benefits to employees, so industry can begin to make an impact in this area. Favorable tax legislation which will increase the value of employer-provided adoption benefits will encourage more corporations to join the leaders in implementing such socially responsible programs. Adoption assistance is presently being discouraged by the tax code since it is considered regular income for tax purposes, and so, companies giving it incur added costs for social security taxes and an extra burden of paperwork.

American Can's new Adoption Benefit, effective January 1, 1982, will pay up to $2,000 per adoption of a child under age 18, to cover legal fees, court costs, medical expenses and agency charges. This benefit is primarily aimed at providing equal treatment for all our employees in the form of some initial financial assistance to those employees who choose to open their homes and their hearts to a child who might otherwise grow up without a family. It seems to us that to subject this benefit to income tax unfairly penalizes people who are merely trying to create loving families, and we strongly urge that benefit payments made for adoptions be treated in exactly the same fashion as benefit payments made on behalf of a natural birth, which are covered by our various employee-choice medical plans.

Committee on Finance, United States Senate
Subcommittee on Taxation and Debt Management
Written Statement by:

Susan Koralik
Partner with Hewitt Associates
600 Third Avenue - 38th Floor
New York, NY 10016

October 16, 1981
Subject of Statement: S. 1479

My name is Susan Koralik and I am a partner and consultant with Hewitt Associates. Hewitt Associates is a firm of independent consultants and actuaries in the area of compensation, employee benefits, communications, and related financial and human resource functions.

Recently we have worked with a number of companies interested in adoption benefits--and today I would like to share some thoughts with you on this subject. Let's consider these four points:

- First, how prevalent adoption benefits are,
- Second, why organizations are considering adoption benefits,
- Third, what companies are actually doing and what kind of problems they are running into,
- And fourth, why Hewitt Associates feels that adoption benefits should be excludable from the taxable gross income of an employee.

Adoption benefits are offered by a small, but growing number of companies. In the summer of 1980, Hewitt Associates talked with 14 companies offering some type of benefit to adoptive parents. Since then, we have talked with a number of companies who have recently established an adoption benefit program or who are now considering such a program. Hewitt Associates started its own adoption benefit plan in April of 1981.

Most of the companies we talked with decided to add an adoption benefit to their benefits package because they feel "it's only fair" to offset some of the costs of adoption. When an employee has a child naturally, the company's medical plan covers doctor bills and hospital expenses. Adoptive parents are not covered by pregnancy benefits, but they may have large expenses through adoption, often greater than if they had a child naturally.

What type of adoption benefits are actually being offered? We've seen three types of plans:

- Type I--Usually there is a reimbursement for specific expenses that adoptive parents incur, such as public or private agency fees, court and legal fees. Other fees might be covered, such as foreign adoption fees, medical examination costs, and pregnancy expenses for the natural mother. Among companies we talked with, the maximum reimbursement varied from $300 to $2,200 and was usually $1,000.
- Type II--Sometimes a company provides a set allowance for an adoption. An employee receives a lump sum, regardless of specific costs involved. In our study, this ranged from $75 to $1,000.
- Type III--In the third type of plan, the company provides for the medical costs related to the adoption process (e.g., those associated with the child's birth) through company medical insurance plans. No legal or court or other associated costs are covered.

One problem companies have experienced with adoption benefits plans is the taxation of benefit awards. It is sometimes hard to explan to an employee that adoption benefits are generally considered taxable income. An employee is often unpleasantly surprised to find out that his or her $1,000 benefit, for example, is substantially reduced by taxes.

We feel virtually all benefits for adoption expenses, provided under a nondiscriminatory employer plan, should be excludable from an employee's taxable gross income.

First, let's look at this issue from the viewpoint of a parent having a child. A parent having a child naturally is able to receive medical benefits that are not part of his or her taxable income. And typically, it is only medical expenses that a parent incurs when having a child. In a similar way, we should encourage parents who want to have a child through adoption. Just as parents receive special tax treatment for the medical expenses of bearing a child, so should there be special tax treatment for the expenses involved in adopting a child.

Second, interest in family related benefits paid by the employer is growing. Employers are much more interested in child care because of the provision of the Economic Recovery Tax Act of 1981 which allows employer payments toward dependent care to be excluded from an employee's taxable income. We feel that if adoption benefits receive similar tax treatment, similar employer interest would be generated.

And third, if adoption benefits are nontaxable, we see even greater numbers of employers making this benefit available as another option under flexible benefit programs. One reason some employers have not considered an adoption benefit plan is that it only affects a small number of employees. But a flexible benefit program gives an employee the ability to choose the benefit coverage which best suits his or her needs. With a flexible benefit program, an employee that needs an adoption benefit could choose it from several nontaxable choices. Other employees can choose other benefits that meet their own needs. Our experience has shown that interest in the idea of flexible compensation is growing. Hewitt Associates is now working with over 70 companies who are looking at flexible compensation programs as the only practical way to meet the varying needs of the diverse workforce of the 80's. In summary, Hewitt Associates feels that any policy that may encourage adoptions is in the best public interest.

Senator PACKWOOD. I have no other questions. Thank you very much for coming today.

We will move on to a different subject, and we have a variety of witnesses and topics on the mortgage bond issue, veterans' bonds, mortgage subsidies, generally. And we will start with Staryl Austin, the Director of the Department of Veterans Affairs in Oregon testifying on S. 425. Good morning. Good to see you again.

Mr. AUSTIN. It is nice to be here.

STATEMENT OF STARYL AUSTIN, DIRECTOR OF DEPARTMENT OF VETERANS' AFFAIRS, SALEM, OREG.

Mr. AUSTIN. Mr. Chairman, for the record, I am Staryl Austin, Jr., the director of the Oregon Department of Veterans' Affairs. And I appreciate very much the opportunity to appear before you today.

I am particularly concerned about the effect of the Mortgage Subsidy Bond Tax Act of 1980 on veterans' home loan programs, and, specifically, the Oregon program.

Our program was conceived early in World War II by a group of Oregon World War I veterans who felt that the State had not treated them well on their return, and that the time to plan for the mass of World War II veterans who would return soon was now. At their insistence, the 1943 regular session of the Oregon Legislature adopted a constitutional amendment which was referred to the people and accepted in 1944. And in 1945, the enabling legislation was passed. Our program has been in continuous operation since 1945.

Since that time, we have made over 256,000 loans for the purchase and improvement of homes and farms. The total dollar volume as of September 30 of this year was $6,651,000,000. You can see from these numbers that we are a very large operation. We have become very important not only to the veteran population of Oregon but to the economy as well.

We were aware of the various forms taken by the Mortgage Subsidy Bond Tax Act of 1980 from its inception in the House Ways and Means Committee in early 1979. Its final form, which came as an amendment to the Omnibus Reconciliation Act of 1980, was not what we had hoped for and we are left with several problem areas because of it.

Senator PACKWOOD. Let me ask you a question. And later on in your testimony you have some testimony on the general problems faced. But what went wrong on those two issues? I know in his past that Congressman Ullman thought—and, by and large, the House took care of the bulk of that bill—thought the Oregon veterans bond program was covered. It was only retroactively we discovered that it was not as far as those two placements. Can you shed some light on what happened?

Mr. AUSTIN. Mr. Chairman, I am not exactly sure what happened. I know what we have heard in Oregon, and essentially it is the fact that the bill became an amendment to the Reconciliation Act rather than the original Ullman bill, and that the details were ironed out in a conference committee. The version that passed had been around, but was not the one that Mr. Ullman thought was going to come through apparently. And we were assured at the beginning, as I think all of the Members of the Oregon congressional delegation were, that the bill itself, as it was coming through in that process, did not affect our program. However, it did. And the first and most immediate effect of that program was the prohibition on refinancing, which is addressed in S. 425. On January 1, 1981, the effective date of the act, about 1,450 Oregon veterans had pending loan applications involving some form of refinancing. The majority of those veterans have now been denied loans totaling more than $66 million because of that restriction.

A major problem relating to the refinancing applications was the absence of the required IRS regulations on the effective date of the act. My deputy director and an assistant attorney general from Oregon who was working with us came to Washington in early January of 1981 to talk to the IRS about the act. After that visit, Oregon's attorney general issued, at my request, a formal opinion setting forth guidelines for us to follow pending issuance of the IRS regulations. The proposed regulations were not issued until July 1, 1981, and are not yet finally adopted. We will appear at a hearing to be held on November 5 on those regulations.

During the 6-month period when we were operating without the regulations, we relied on our attorney general's opinion for the definition of what constitutes "interim financing." That opinion, and our experience of 35 years in dealing with interim loans, indicated that a 2-year loan was about the minimum available from any source, and that many loans up to 5 years in length were treated as interim loans by other lending institutions. Our attorney general suggested that we use the 2-year limit pending issuance of regulations. And what happened there is that we actually did use that limit pending issuance of the regulations, but on July 1 when the regulations were published, we still had people out who, at our advice, had obtained interim financing which was up to 2 years in length. So they were caught, on our advice and on the advice of Oregon's attorney general, in a situation where we could not honor their request.

The proposed regulations which were issued on the 1st of July limited interim financing for a period of 6 months. In our judgment, that limit is arbitrary and is absolutely unrealistic. We request that the committee consider some action which would allow the broader definition of "interim financing."

We believe that 2 years is a realistic minimum time for such financing, and we will make an appeal to IRS for that modification on the 5th of November.

A simple, and, in my judgment, realistic approach to the problem I have outlined would be to repeal a portion of the 1980 amendment to the Internal Revenue Code of 1954. Specifically, Internal Revenue Code section 103A(c)(3) defines a qualified veteran mortgage bond. It is defined for the purposes of this section, the term "qualified veterans' mortgage bond" means "any obligation, (*a*) which is issued in registered form as part of an issue substantially all of the proceeds of which are to be used to provide residences for veterans; (*b*) the payment of the principal and interest on which is secured by a general obligation of a State; and, (*c*) which is a part of an issue which meets the requirements of subsection (j)(2)."

It is subsection (j)(2) which provides that no part of the proceeds of a bond issue may be used to acquire or replace existing mortgages. Repealing subsection (c) of the definition of a qualified veterans mortgage bond would eliminate that reference and would solve our problem.

An additional problem faced by the program, but not yet in place, is the act's requirement that qualified veterans' mortgage bonds be in registered form beginning on July 1, 1982. That subject has, or will be, presented to you by our deputy State treasurer, Fred Hansen. And I understand that testimony is to be submitted in writing rather than verbally. I mention it only to advise you that the department of veterans' affairs strongly supports that position.

I also would disagree with a remark that was made by Secretary Chapoton a few moments ago in his estimate of cost of registration of bonds. We have talked at length with our advisers and contacts in the marketplace, and the indication they give us is a 60-to-100-basis point penalty for that process, six-tenths of 1 percent to 1 percent of interest.

Senator PACKWOOD. In case I forget to ask, I might ask other witnesses to comment on that. That is normally what I have heard, that if you are going to register these, there is going to be a significant increase in cost. And if there is a way you can accomplish registration without any increase in cost, I am not sure of much objection, but I would appreciate the other witnesses also talking about that issue.

Mr. AUSTIN. I think we would be interested in talking with Mr. Chapoton and finding out what that method is.

An even broader and more acceptable approach, as far as veterans are concerned, might be to consider that only six States had veterans' home loan programs in place on January 1, 1981. Those State programs could be exempted from the Mortgage Subsidy Bond Tax Act of 1980 on the basis that they were in existence, were regulated by the States and were providing a needed service to veterans. Such a compromise would protect preexisting programs and would allow any new State-generated programs to be put in place under the terms of the act.

I would also call to your attention a resolution adopted at the recent annual meeting of the National Association of Directors of Veterans' Affairs, calling for an outright repeal of that portion of the Mortgage Subsidy Bond Tax Act of 1980 which regulates qualified veterans' mortgage bonds. That resolution has been provided to you from another source. I mention it here only to advise you that we in Oregon had a part in its development and that we supported it at the time it was accepted.

Mr. Chairman, also with me in the audience, and not testifying today, is Gary Lockwood from the State military department in Oregon, and he is concerned about the IRS regulation, use of the definition of "veteran." It goes to the United States Code, which is a proper place, but we find that the definition in the United States Code, in title 38, has kind of been overtaken by time, and it eliminates people who are actually on active duty in what is defined as a training status, but it is under title 10 of the United

States Code, the same as extended active duty personnel who serve in the regular forces.

Now, there has been a movement in Oregon for the last four sessions of the legislature to arrange a method for Guard members to participate in our program as an incentive for retention. The Mortgage Subsidy Bond Tax Act of 1980, with that definition, eliminates the possibility of our including members of the Guard under our program. So I would commend his written testimony to you as well.

[The prepared statement of Staryl C. Austin, Jr., follows:]

Department of Veterans' Affairs
GENERAL SERVICES BUILDING, 1225 FERRY STREET S.E., SALEM, OREGON 97310

October 16, 1981

STATEMENT BY STARYL C. AUSTIN, JR., DIRECTOR,
DEPARTMENT OF VETERANS" AFFAIRS, STATE OF OREGON

Mr. Chairman, members of the committee:

For the record, I am Staryl C. Austin, Jr., Director of the Oregon Department of Veterans' Affairs. I appreciate the opportunity to appear before you today to discuss our farm and home loan program for veterans, and the effect of the Mortgage Subsidy Bond Tax Act of 1980 (Public Law 96-499, Section 1101 et seq.)

Our program was conceived early in World War II by a group of Oregon World War I veterans who felt that the State had not treated them well on their return, and that the time to plan for the mass of World War II veterans who would return in the near future was at hand. At their insistence, the 1943 session of the Oregon Legislature adopted a Constitutional Amendment which was referred to the people and accepted in 1944. The 1945 Legislative session then adopted the enabling statutes. Our program has been in continuous operation since that time.

Since 1945 we have made 256,973 loans for the purchase and improvement of homes and farms. The total dollar volume as of September 30th of this year was $6 billion 651 million dollars. You can see from those numbers that we are a very large operation. We have become very important not only to our veteran population, but to the economy of Oregon.

We were aware of the various forms taken by the Mortgage Subsidy Bond Tax Act of 1980 from its inception in the House Ways and Means Committee in early 1979. Its final form, which came as an amendment to the Omnibus Reconciliation Act of 1980, was not what we had hoped for, and we are left with several problem areas because of it.

The first and most immediate effect was the result of the prohibition on refinancing contained in the Act. On January 1, 1981, the effective date of the Act, about 1450 Oregon veterans had pending loan applications involving some form of refinancing. The majority of those veterans have now been denied loans totalling more than $66 million dollars because of that restriction.

A major problem relating to the refinancing applications was the absence of the required Internal Revenue Service regulations on the effective date of the Act. My Deputy Director and an Assistant Attorney General, who was working with us, came to Washington in early January, 1981, to talk to the IRS about the Act. After that visit, Oregon's Attorney General issued, at my request, a formal opinion setting forth guidelines for us to follow pending issuance of regulations by IRS. The proposed IRS regulations were not issued until July 1, 1981, and are not yet finally adopted. We will appear at a hearing concerning those regulations on November 5th.

During the six month period when we were operating without IRS Regulations, we relied on our Attorney General's Opinion for the definition of what constitutes interim financing. That opinion, and our experience of thirty five years in dealing with interim loans, indicated that a two year loan was about the minimum available from any source, and that many loans up to five years in length were treated as interim financing by other lending institutions. Our Attorney General suggested we use the two year limit pending issuance of regulations.

The proposed IRS Regulations, issued on July 1, 1981, limit interim financing to a period of six months. In our judgement, that limit is arbitrary and absolutely unrealistic. We request that the committee consider some action which would allow the broader definition of interim financing. We believe that two years is a realistic minimum time for such financing. We will make an appeal to IRS for that modification on November 5.

A simple, and, in my judgement, realistic approach to the problem I have oulined would be the repeal of a portion of the 1980 amendment to the Internal Revenue Code of 1954. Specifically, IRC section 103A(c)(3) defines a qualified veteran mortgage bond:

> "(3) QUALIFIED VETERANS' MORTGAGE BOND DEFINED. --
>
> For purposes of this section, the term 'qualified veterans mortgage bond' means any obligation - -
>
> (A) Which is issued in registered form as part of an issue substantially all of the proceeds of which are to be used to provide residences for veterans,
>
> (B) the payment of the principal and interest on which is secured by the general obligation of a state, and
>
> (C) which is part of an issue which meets the requirements of subsection (j)(2)."

It is subsection (j)(2) which provides that no part of the proceeds of a bond issue may be used to acquire or replace existing mortgages. (IRC sec 103A(j)(2)). Repealing subsection (c) of the definition of a qualified veterans mortgage bond would eliminate that reference and solve our problem.

An additional problem faced by the Oregon program, but not yet in place, is the Act's requirement that Qualified Veterans Mortgage Bonds be in registered form beginning on January 1, 1982. That subject has (or will be) presented to you by our Deputy State Treasurer, Mr. Fred Hansen. I mention it only to advise you that the Department of Veterans' Affairs strongly supports his position.

An even broader and more acceptable approach might be to consider that only six states had veterans home loan programs in place on January 1, 1981. Those State programs could be exempted from the Mortgage Subsidy Bond Tax Act of 1980 on the basis that they were in existence, were regulated by the States and were providing a needed service to veterans. Such a compromise would protect pre-existing programs and would allow any new State generated programs to be put in place under the terms of the Act.

I would also call to your attention a resolution, adopted at the recent Annual meeting of the National Association of Directors of Veterans Affairs, calling for outright repeal of that portion of the Mortgage Subsidy Bond Tax Act of 1980 which regulates Qualified Veterans Mortgage Bonds. That resolution has been provided to you from another source. I mention it here only to advise you that we in Oregon had a part in its development and that we supported it at the time it was adopted.

Mr. Chairman, that completes my prepared statement. I will be glad to respond to questions.

Senator Packwood. I saw Gary in the audience. He is an old, long-standing friend of mine.

Mr. Austin. Are there any questions, Mr. Chairman?

Senator Packwood. General, I have no more questions. Dave?

Senator Durenberger. No questions, Mr. Chairman.

Senator Packwood. Thank you very much for taking the time to come back. I appreciate it.

Mr. Austin. I appreciate the opportunity. Thank you.

Senator Packwood. Now, we will take a panel consisting of Mr. A. L. McNitt, Gregg Smith, Grady Haynes, James Dinerstein, and Richard Helmbrecht.

Senator Durenberger. Mr. Chairman, if I might before this panel proceeds, and I am conscious as I always am of your willingness to cover an awful lot of territory and try to do it in a short period of time, but because of my own particular concern for the problem of mortgage revenue bonds, let me make a few brief comments and then put in a more complete statement in the record.

None of us need to restate the critical shortage of affordable housing in this country.

We need to recognize that during July of this year we spent an awful lot of time adjusting the Tax Code for some of those realities. We have done some things to make savings a little more attractive and a lot of things to boost private investment in low-income housing. But there are some other things also that are going on. The Presidential Housing Commission is about ready to recommend a change from construction incentives under section 8 and other subsidy programs to a greater role for consumers. On Monday morning next week the Intergovernmental Relations Subcommittee of Governmental Affairs, which I chair, will be holding a 3-hour hearing on consumer financing alternatives to the present Federal programs which finance builders of shelter rather than persons in need of shelter. But it seems to me that the whole issue of mortgage revenue bonds is an absolutely essential part of the access of low- and moderate-income persons to shelter over the foreseeable future of this country.

The remedial legislation which was passed as part of the Omnibus Reconciliation Act of 1980 has virtually shut down the entire mortgage revenue bond program. I am not totally familiar with the dollar figures, but I know that only four bond issues have been sold successfully since that law took effect. My own State of Minnesota, from which you will hear a couple of representatives this morning, was within 24 hours of selling an issue when the regulations this July were issued, and over half the issue was returned unsold because bond counsels could not be sure the issue would comply with all of the new regulations. So we have a combination of some legislative efforts to do things right and some regulatory efforts when Treasury was busy doing other things that I think may have been well intentioned but have created substantial problems.

I think some of the witnesses this morning will talk about the long-range, broader course we ought to be on, but most of them will be talking about our near-term future in this country and some of the things that are absolutely essential to create workability in our present program.

The bill that Senator Sasser put in, S. 1348, is somewhat of a broader range effort than is my bill, S. 1656. And I just want you to know that it is my particular purpose to deal with the near term, to deal with only those problems that I have felt, and a lot of people who have helped with this legislation has felt, they are just absolutely essential to create some reality in the mortgage revenue bond market. We have not tried to exaggerate anything. We have not tried to solve all of the problems of the world, but just deal with the present realities. And I trust that many of these witnesses here this morning will address themselves to the near term solution, which is not all that complicated. They just need our attention, our support, and some action by both Treasury and the Congress. And I appreciate your giving us the time and I appreciate the efforts of all the witnesses that have come here today and to be relatively concise, I imagine, about their presentation of the problems and the solution.

Senator PACKWOOD. Dave, your statement is very valid in more respects than I think you realize. I recall when this limitation was passed. And, as I said to Secretary Chapoton today, although that was under a different administration, the normal tendency of Treasury Departments is they want to put the clamp on all fringe benefits and all industrial revenue bonds and all housing bonds, because it interferes with the otherwise apparently orderly process of Government as they see it, which is a completely uncomplicated tax code. And that is not the only end of Government.

Most of the housing bond programs in this country, be they veterans' programs or otherwise, have worked well. They have provided housing for people who might not have otherwise afforded it. They have provided jobs. To the best of my knowledge, they have been as scandal-free as any programs the Government runs, and yet they are an anathema to Treasury Departments, plural, Republican or Democrat. And I hope by the time we are done with the hearings we can work out a bill that will be acceptable to the Treasury, but, if not, we will work out a bill that is unacceptable to the Treasury. [Laughter.]

Mr. McNitt, go right ahead.

STATEMENT OF A. L. McNITT, ADMINISTRATOR OF THE NEVADA HOUSING DIVISION, CARSON CITY, NEV.

Mr. McNITT. We certainly appreciate your comment, Senator. On behalf of Governor List and as an officer of the State of Nevada, the following testimony is presented to the Finance Subcommittee on Taxation and Debt Management. And I would like to respond to a question you had with regard to registration costs. I am advised by a member in the audience who is an officer of our underwriting team that we could consider in today's bond market anywhere from 50 to 75 additional basis points across the board of cost of registration since these would be the only bonds which would have to be registered as tax free municipal finance.

Also, I am advised by our trustees in the State of Nevada, trustee banks, that the cost of establishing and operating programs that have registered bonds would cost us anywhere from an additional 5 to 10 basis points to establish them and operate them. That is roughly twice the cost we now incur, and that is a continuing cost over the life of the bond program.

Second, I have been asked to remind that the State of Nevada, in January 1981, following the passage of the Mortgage Subsidy Bond Tax Act of 1980, and at the direction of Gov. Robert List, suspended its single-family program. We have not issued any additional bonds. We do not anticipate issuing any additional bonds, pursuant to that statute, nor the current draft regulations issued by Treasury. We don't feel it is workable.

First, the State of Nevada supports the immediate passage of S. 1348 as a partial, temporary solution to the inequities unilaterally imposed by Congress on the several States by the Mortgage Subsidy Bond Tax Act of 1980. The more appropriate remedy, however, is a 100-percent repeal of the act rather than these proposed amendments.

Second, the Governor of the State of Nevada has gone on record that any efforts by the Congress or executive branch to tax or regulate municipal finance must be opposed vigorously by the State. The history of such a position goes back into the history of our Constitution.

Third, it is the view of the State of Nevada that there is a sufficient probability, or possibility, that the Mortgage Subsidy Bond Tax Act of 1980 is unconstitutional because (1) the power of the Federal Government to regulate the States is, at best, a limited power, and there is serious question that the act, in part or whole, exceeds the powers of the Federal Government; (2) the doctrine of reciprocal immunity from taxation has been established since the *Collector* v. *Day* case in 1871. Reciprocal immunity was extended then to just income earned on State securities in *Pollack* v. *Farmers' Loan and Trust Company* case in 1895. The act unilaterally breaches this reciprocal immunity from taxation without Congress changing the Constitution to authorize it to tax State and municipal securities; (3) the act directly interferes with one of this State's traditional governmental functions and thereby impairs this State's integrity and ability to function effectively in the Federal system.

The act (a) impairs the State's function with a sunset provision which eliminates all single-family mortgage bond programs after 1983, and (b) currently impairs the State's function with permanent rules which have made new single family bond issues impossible to issue to date.

Fourth, the *Amersbach* v. *City of Cleveland* case that is currently in the Sixth Circuit Court of Appeals has not been reviewed by the Supreme Court. However, the enclosed opinion by the Nevada attorney general indicates that both the single and multifamily housing division programs can meet the four-pronged test formulated in that case; therefore, the single and multifamily programs constitutionally would not be taxable by the Federal Government.

Fifth, the 16th amendment did not extend any constitutional powers to Congress to tax State and municipal securities. During the ratification process, Congress acknowledged this and the Supreme Court confirmed it in the *Evans* v. *Gore* case, 1920.

The Mortgage Subsidy Bond Tax Act of 1980 is inconsistent with President Reagan's policies on federalism and the return of powers and responsibilities to the States.

Any efforts by Congress and the executive branch to control, regulate or tax municipal finance is an unconstitutional unilateral taking of State powers and tax revenues to which the Federal Treasury is not entitled. This remains true regardless of the volume of municipal finance.

Sixth, instead of trying to use regulation and taxation or municipal finance as a tool to balance the Federal budget, as had the Carter administration attempted, the more proper approach would be to recognize and respect that (1) any recent expansion of usage or volume in the municipal finance activities has been caused by State and local governments responding to high interest rates caused by high inflation. High inflation has been caused by excessive Federal budget deficits, excessive Federal Government spending, as a percentage of gross national product and excessive increases in the monetary supply; (2) the best solution for the Federal Government is to spend the majority of its efforts to solve high inflation which, in turn, will solve high interest rates. Then the political need to use municipal finance will diminish and so will the perceived loss of tax revenues for the U.S. Treasury.

Seventh, the Treasury Department seeks the end of all municipal finance free from Federal regulations and taxation. Treasury is justifying its attitude on the basis that the 1968 Federal industrial development bond statute never has been challenged nor overturned; therefore, this is sufficient precedent to justify Federal regulation and taxation of other municipal finance activities. IDB's are not sufficient nor strong precedent for Federal regulation of municipal finance. The only reason there has been no direct constitutional challenge of the 1968 IDB law, nor the 1959 arbitrage regulations, is because the abilities of the States to function within the Federal system have not been impaired.

Eighth, the States and municipal governments, in order to preserve our system of federalism, must never give up their rights to finance their functions free from Federal regulation and taxation.

Ninth, the States and municipal governments, in order to preserve our system of federalism, must not accept taxable municipal finance with Federal interest rate subsidies as any alternative to their present constitutional rights to issue municipal finance free from Federal taxation and regulation.

Tenth, Congress and the executive branch should support the return of balance to our fine federal system.

We have attached for further reference two documents. The first is an opinion from the office of the attorney general of the State of Nevada which analyzes the constitutional history of Federal taxation efforts of interest earned on State housing bonds and jurisdiction with the U.S. Supreme Court for legal recourse. The second document contains key pages from the "Tax Revision Compendium, 1958," wherein Congress, in 1910, said it clearly did not have any constitutional power nor intent to tax State and municipal securities.

In summary, for the several reasons cited, the State of Nevada proposed that full repeal of the Mortgage Subsidy Bond Tax Act of 1980 is the more appropriate action. However, as a partial, temporary solution we do support immediate passage of S. 1348 with the understanding that we will continue all efforts to fully repeal the statute.

And we thank you very much.

[The documents follow:]

EXEMPTION OF INTEREST ON STATE AND MUNICIPAL BONDS

Cushman McGee

Your honorable committee is presently reviewing certain provisions of the Internal Revenue Code of 1954, and it has requested from a limited number of persons statements concerning various features of the code, among them the provisions of section 103(a)(1) which expressly exclude from gross income interest on "the obligations of a State, a territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia."

This statement is presented with the aim of delineating the grave consequences of any attempt to change the provisions of law relating to the immunity from taxation of the interest on obligations of a State or any political subdivision thereof. It is especially my intent to mention facts of current and future importance relating to the fiscal problems of States and their political subdivisions, which should now be recognized as having a material bearing on this subject.

Consistent with your invitation, this statement is submitted only in an individual capacity. I do not appear on behalf of any organization whatsoever, and my observations reflect solely my personal opinions.[1]

The listing of a discussion of municipal bonds in the current series of hearings being held by your committee implies that the exclusion of interest on such bonds from gross income is or may be considered as a loophole for the avoidance of income taxes.[2] To the contrary, in my opinion, any proposal for taxation of such interest would be unconstitutional, seriously harmful to the economic and financial condition of the States and their subdivisions, and highly prejudicial to the maintenance of the duality of State and Federal Government which was so well devised by the authors of the Federal Constitution.

I. THE CONSTITUTIONAL BASIS OF THE LAW

Before undertaking a presentation of pertinent economic and financial factors, I believe that it is of primary importance to review briefly the constitutional basis of the law. Fundamentally, this is that both the Federal Government, on the one hand, and the several States, on the other hand, are immune from taxation by the other. Hence, the doctrine of immunity is reciprocal. Furthermore, it extends to the instrumentalities of the Federal Government and of the States, respectively. The application of this doctrine to the subject under consideration was well stated by the Honorable Colin F. Stam, as follows:

> The Federal Government has no power to tax the obligations or the interest therefrom of a State or political subdivision. This limitation is not based upon any express prohibition in the Constitution but is implied from the independence of the National and State Governments within their respective spheres and from the provisions of the Constitution looking toward the maintenance of our dual system of government * * *."[3]

The contention that the Federal Government has power to tax interest on bonds of the States and their instrumentalities is predicated upon an interpretation of the 16th amendment to the Constitution of the United States, which has been convincingly shown to be erroneous.[4]

Origin of the 16th Amendment

Prior to the adoption of the 16th amendment, the Congress indisputably had power to levy an income tax upon certain kinds of income, such as salaries and professional income.[5] However, after the Congress enacted the Revenue Act of 1894, attempting also to tax the incomes of persons and businesses derived from property, rent, interest, and dividends, the act was challenged in the courts in the Pollock case.[6] The tax on income derived from real property was held to be a direct tax, subject to apportionment, in accordance with the requirement of the Federal Constitution which reads, "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."[7] While the Congress thereafter might have imposed an income tax, it could not do so in a practical manner to reach comprehensively the incomes of persons and businesses. Consequently, there was popular sentiment in many sections of the United States for a constitutional amendment which would eliminate the requirement of apportionment. The Congress initiated such an amendment in the following wording, which after ratification, became the 16th amendment:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Subsequent to the receipt by the Congress on June 16, 1909, of a message from President William Howard Taft recommending a constitutional amendment to overcome the rule of Pollock case, the Congress formally adopted the wording of the amendment on July 12, 1909, for submission to the States. During the prior discussion of the proposal in both the Senate and the House there was no hint whatsoever that any Senator or Representative considered that the proposal would broaden the power of the Federal Government to invade the immunity of the States and their subdivisions.[8]

Then current interpretations

One of the first governors, if not the first, to comment upon the then proposed amendment in relation to the immunity rule was Charles Evans Hughes of New York. In his message to the legislature on January 5, 1910, he said in part:

> But the power to tax incomes should not be granted in such terms as to subject to Federal taxation the incomes derived from bonds issued by the State itself or those issued by municipal governments organized under the State's authority. To place the borrowing capacity of the State and of its governmental agencies at the mercy of the Federal taxing power would be an impairment of the essential rights of the State, which, as its officers, we are bound to defend.* * * *[9]

Taking cognizance of the Governor's apprehensions, Senator William Borah of Idaho replied from the floor, giving assurance that the apprehensions were unfounded. Among other statements, the following appears in the record of his speech:

> To construe the proposed amendment so as to enable us to tax the instrumentalities of the State would do violence to the rules laid down by the Supreme Court for a hundred years, wrench the whole Constitution from its harmonious proportions and destroy the object and purpose for which the whole instrument was framed.* * *[10]

6

On February 17, 1910, Senator Elihu Root of New York wrote to a member of the New York Legislature on the subject. Some of the pertinent statements in his letter are as follows:

> I do not consider that the amendment in any degree whatever will enlarge the taxing power of the National Government or will have any effect except to relieve the exercise of that taxing power from the requirement that the tax shall be apportioned among the several States * * *.
>
> The amendment consists of a single sentence, and the whole of it must be read together. It expresses but a single idea, and that is that the tax to which it relates must be laid and collected without apportionement among the several States and without regard to any census or enumeration,* * *.
>
> There was no question in Congress or in the courts, or in the country about the taxation of state securities. No one claimed that the inability of the General Government to tax them was an evil. The inability to tax them did not arise from the terms of the Constitution, but from the fact that, being the necessary instruments of carrying on other and sovereign governments, they were not the proper subject of national taxation, and that therefore no provisions of the Constitution, however wide the scope of their language, could be held to apply to such securities or to the income from them. Judge Cooley, in his work on "Constitutional Law," says:
>
> > "The power to tax, whether by the United States or by the States, is to be construed in the light of and limited by the fact that the States and the Union are inseparable, and that the Constitution contemplates the perpetual maintenance of each with all its constitutional powers, unembarrassed and unimpaired by any action of the other. The taxing power of the Federal Government does not therefore extend to the means or agencies through or by the employment of which the States perform their essential functions, etc."
>
> This rule of construction has been maintained for generations. It is undisputed; it was referred to with approval by the Justices who wrote and delivered the opinions in the Pollock case both for and against the judgment. It has been declared again and again by the Supreme Court to be not open to question. It is a rule of construction just as controlling in defining the scope of the proposed amendment as it is in defining the scope of the existing provisions. Under it, from the earliest times of our Government, the apparently unlimited taxing power conferred by the terms of the Constitution has been held not to apply to the instrumentalities of the State. Under it acts of Congress which, by their express terms, appeared to include instrumentalities of state government have uniformly been held not to include them.
>
> This uniform, long-established, and indisputable rule applied to the construction of our Constitution--a rule which has been declared to be essential to a continuance of our dual system of government--forbids that the words of that instrument conferring the power of taxation shall be deemed to apply to anything but the proper subjects of national taxation. Under it we are forbidden to apply the words, "from whatever source derived" in the proposed amendment to any of the instrumentalities of State government* * *."

The entirety of Senator Root's letter was printed in the Congressional Record on March 1, 1910.[11]

The previously mentioned speech and letter were publicized in newspapers, and they, or the subject of State immunity in relation to the proposed amendment, were commented upon by a number of Governors in public statements.[12] Thus the interpretations of Senators Borah and Root were clearly and widely known, and were publicly supported by a number of Governors prior to the approval of the amendment by the required number of States. Ratification was formalized on February 25, 1913.[13]

Later interpretations of Amendment XVI

It is especially worthy of note that after serving as Governor of New York and as a Justice of the Supreme Court of the United States, and before being appointed as Chief Justice of the United States, Charles Evans Hughes was engaged in the private practice of law. While so engaged, he rendered an opinion on November 10, 1925, advising the Port of New York Authority that the interest on its securities was constitutionally immune from Federal income taxation, citing the Pollock case, among others.[14] After becoming Chief Justice, Mr. Hughes wrote or concurred in numerous opinions of the Supreme Court which refer to the doctrine of immunity in connection with State or governmental bond interest. One of his opinions for the Court appeared in James v. Dravo Contracting Co., where, despite his holding that the gross receipts of a contractor for the Federal Government were taxable by a State, the Chief Justice said of the doctrine of reciprocal immunity with respect to Government bonds.

> That doctrine recognizes the direct effect of a tax which "would operate on the power to borrow before it is exercised" (Pollock v. Farmers' Loan & T. Co., 157 U.S. 429* * *) and which would directly affect the Government's obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit--considerations which are not found in connection with contracts made from time to time for the services of independent contractors.[15]

In the light of the legislative history concerning the origin and ratification of the 16th amendment, it seems fair to assert that the provisions of the Internal Revenue Code appearing in section 103(a)(1), when enacted, constituted an acknowledgement by the Congress of the inherent right of the States to this immunity.[16]

Summary of later congressional action

Proposals for altering the statute or amending the 16th amendment were considered by congressional committees during at least six different sessions from 1918 to 1951. Each time the proposals were defeated in committee or on the floor. Furthermore, a proposal to tax the interest on bonds of public housing authorities was defeated on the floor of the House in 1959.[17]

At its hearings in 1951, the Committee on Ways and Means listened to many witnesses and received hundreds of communications or briefs from Governors, attorneys general, other State officials, mayors, corporation counsels, other local officials, and officers of representative organizations. Among the organizations so represented were the National Association of Attorneys General, the U.S. Conference of Mayors, the National Institute of Municipal Law Officers, the American Municipal Association, the Municipal Finance Officers Association of the United States and Canada, the National Association of County Officials, the Conference on State Defense, and the American Public Power Association.[18]

Since 1951 State and local officials have had no reason to modify or alter their views as to the importance of the doctrine of immunity. Their expert knowledge of the detrimental effect of any breach in the doctrine is reflected in the resolutions which they have adopted from time to time whenever any question concerning the continuity of the doctrine has been raised.

Since I am not an attorney, I leave to members of the bar discussion of the ruling case law. It is my understanding, however, that there is ample support for the conclusion that the immunity of the States and their subdivisions from Federal taxation is neither a privilege nor a subsidy granted by the United States, and that such immunity may not be altered without the consent of the States, given by ratification (by a vote of three-fourths of the States) of a constitutional amendment to that effect.[19]

Footnotes:

[1] The author's knowlege arises from experience since 1927 as an active investment dealer and financial adviser specializing in the marketing of State and municipal bonds, except during two periods of public service which intensified that experience. The first of those periods was as finance examiner, and chief of section, in the Finance Division of the Federal Emergency Administration of Public Works in 1933-34, and the second as Deputy Comptroller of the State of New York in 1949 and 1950. During 1952-59, he also served as a citizen member of the (New York) temporary State highway finance planning commission, and during 1954-56, as such a member of the temporary State commission on educational finances. Both of these commissions concluded their work with legislative proposals which in substance were enacted into law, including one proposition which was adopted by the people at a State referendum. Presently, the author is serving, by invitation, as a member of the State comptroller's committee on the local finance law.

He is a native of Michigan and for 30 years lived in or near Detroit. Since 1934 he has resided mostly in Westchester County, N.Y., where he is now living.

[2] For brevity, the term "municipal bonds," when used in this statement, unless the context otherwise implies, means the obligations of a State or of a municipality (as the term "municipality" is defined below), or all such bonds in the aggregate.

The terms "municipality," "locality," and "subdivision," and their plurals mean any or all municipal corporations, political subdivisions, school districts, and other districts, agencies, departments, and authorities created by a State or existing as the result of State or local governmental enactments.

"General obligation bonds" means obligations issued by a State or municipality, or all of them, for which the full faith, credit, and taxing power of the respective issuers are pledged in payment. Inasmuch as general taxing power is involved, such bonds are to be distinguished from revenue bonds.

"Revenue bonds" means obligations issued by a State or municipality, or any of them, which are payable solely from the pledge income or revenues of a certain facility, or from a specifically pledged tax or source of receipts rather than from general taxes of the issuer.

"Public housing authority" or "public housing agency" means any or all public corporations, State or local agencies, which have issued or may issue obligations to construct, acquire, or operate housing facilities for occupancy by the public. Included in this term are the public housing authorities and housing commissions which have issued or may issue new housing authority bonds pursuant to annual contributions contracts between such authorities or commissions and the Public Housing Administration of the United States.

Footnotes cont.

[3] "The Taxing Power of the Federal and State Governments, Report to the Joint Committee on Internal Revenue Taxation of the Senate and House of Representatives" (Oct. 8, 1966).

[4] The incorrect interpretation is presented in "Taxation of Government Bondholders and Employees--The Immunity Rule and the 16th Amendment, a study made by the Department of Justice," 210 pages, Washington; 1938. This interpretation is refuted in "The Constitutional Immunity of State and Municipal Securities--A Legal Defense of the Continued Integrity of the Fiscal Powers of the States, by the Attorneys General of the States and Counsel for Certain of Their Municipal Subdivisions," 420 pages, about 1939, (This volume is hereinafter cited as "The Attorneys General.")

[5] A tax on income was upheld in Springer v. United States, 102 U.S. 586 (1880).

[6] Pollock v. Farmers' Loan and Trust Co., 157 U.S. 429 (1895); on rehearing, 158 U.S. 801 (1895).

[7] Constitution, art. I, sec. 9, par. 4.

[8] "The Attorneys General," op. cit. pp. 260-285.

[9] "Public Papers of Governor Hughes," pp. 71, 73, as quoted in 45 Congressional Record, p. 2245 (Feb. 28, 1910).

[10] 45 Congressional Record, p. 1698 (Feb. 10, 1910).

[11] 45 Congressional Record, pp. 2589, 2540 (Mar. 1, 1910).

[12] "The Attorneys General," op. cit., pp. 312-325.

[13] The ratification of the 16th Amendment was the subject of a proclamation by the Secretary of State on Feb. 25, 1913. Thirty-six States had then approved the amendment.

[14] "The Attorneys General," op. cit., p. 287.

[15] James v. Dravo Contracting Company, 302 U.S. 134, 153 (1937).

Footnotes cont.

[16] The statutory exemption was set forth in the first Income Tax Act, adopted Oct. 3, 1913, effective as of Mar. 1, 1913, and it has been reenacted from time to time without lapse.

[17] 105 Congressional Record, p. 7951 (May 21, 1959), reporting the defeat of a proposed amendment to the U.S. Housing Act of 1937 which would have provided for taxation of interest on certain future issues of local housing authority bonds. The proposed amendment was defeated by a vote of 70 ayes and 199 noes.

[18] Hearings before the Committee on Ways and Means, 82d Cong., 1st sess., 1951, pt. 2, pp. 903-1159.

[19] The necessity of a constitutional amendment was recognized by a number of the earlier advocates of a change in the doctrine of immunity. This was the conclusion expressed by the Honorable A. W. Gregg, Assistant to the Secretary of the Treasury, in a letter dated Jan. 4, 1924, to the Chairman of the Committee on Ways and Means, 65 Congressional Record, pp. 8204-8206 (May 9, 1924).

Senator PACKWOOD. Mr. McNitt, thank you. Let me say again to the witnesses that I have read all of the statements that were in as of last night. And so if you can abbreviate them so we can stay within the 5 minutes for each of the witnesses on the panel I would appreciate it.

Gregg Smith, administrator of the Oregon Housing Division in Oregon.

STATEMENT OF GREGG SMITH, ADMINISTRATOR OF THE OREGON HOUSING DIVISION, SALEM, OREG.

Mr. SMITH. Mr. Chairman, and members of the committee, my name is Gregg Smith. I am administrator of the Housing Division of the State of Oregon and I am here to testify in favor of S. 1348. I would like to give you a brief overview of State housing finance agency operations. We have been in operation nationwide for about 20 years. Basically, our programs have served low and moderate income renters and home buyers. We fill a gap between Federal programs which serve, primarily, low-income renters, and conventional lending programs which are basically aimed at people with above median incomes.

In the 1970's we got involved, as agencies, in single-family housing programs in a larger way. I would like to call your attention to attachment A of my testimony which synopsizes the data from our program in 1980. It shows that basically we served young, moderate income, first-time home buyers who are buying small, older, starter homes in urban areas.

As you know, in 1978, certain cities and counties started getting involved in this type of housing finance. We opposed those efforts. We questioned the public purpose of them in many cases. Our initial support of congressional efforts to put restraints on this particular type of activity has borne bitter fruit.

What happened was not restraint but abolition of the good programs along with the bad. Perhaps this was oversight. I talked with former Representative Al Ullman about this matter in 1979, he told me that the bill that came out of the Ways and Means Committee was flawed. He recognized that. But he said it was the best bill he could get at the time. But he told me, "Don't worry, there will be time to work on it in the Senate."

Unfortunately, that never happened. The House bill became law through the conference committee action on the Omnibus Reconciliation Act.

Senator, we can live with the programmatic restraints in that legislation. What we cannot live with are certain technical elements, namely, the good faith question, the arbitrage limits and the registration requirement.

Other people here today are going to talk about arbitrage and good faith. I want to talk about registration. And I would like to contest the statements made by the Assistant Secretary from the Treasury.

On June 23, the State of Oregon had a general obligation bond issue. Within that sale were two separate issues. One was for alternative energy projects and the other was for water resource facilities. The energy bonds were required by Federal law to be registered. When the net interest costs were compared between the two issues, there was a 70 basis point differential. Now, if you correct for differences in structuring, it probably worked out to be more like 50 basis points. That is a half percent. That is a tremendous amount of additional cost over the life of the bonds.

For example, if we look at the housing bonds sold under the transition rules in 1980, and we assume that all of those had to be registered, the additional interest cost that we would have had to pay would have been almost $2 billion. That's $2 billion of additional tax exempt interest in the market. Now, the Treasury, I am sure, would assert there are certain problems in this area; that people are avoiding estate taxes because they ferret away bonds in safe deposit boxes, and then someone gets to the safe deposit box before the auditor does. Perhaps this happens. I am not saying that it doesn't happen. But the solution that they have proposed, if I may, is like killing mosquitoes with MX missiles.

Registration dramatically increases borrowing cost and it inhibits secondary market transactions. It puts more tax exempt interest in the market, and it creates added paperwork. Perhaps it is because of these negative features that Federal Government bonds are not registered.

To summarize, Senator, we believe it is a valid public purpose for States to provide opportunities for young, first-time home buyers to purchase homes. We have created programs with small staffs, at low cost, to accomplish this objective. We have worked cooperatively with the private sector to serve a client group the private sector cannot serve. We know that capital is moving out of housing into other areas. Federal resources for housing are declining. We believe that a response is warranted. We have a vehicle for meeting that need and we would like to be able to be sunrised, Senator, so that we can get on with the job. Thank you, sir.

Senator PACKWOOD. Gregg, as usual, very good. Let me ask you just a quick question. I did not practice a great deal of probate law when I practiced in Oregon, but as I recall, I could not get into the safety deposit box of a decedent without somebody from the State tax commission being there to inventory the documents as we took them out. Has that law changed or is that still the law?

Mr. SMITH. Senator, I am not an attorney, but that sounds to me like that is the right procedure. Perhaps Mr. Chapoton should be aware of that.

Senator PACKWOOD. Very hard to sneak anything by them in that box.

Mr. Haynes.

STATEMENT OF GRADY HAYNES, PRESIDENT, TENNESSEE HOUSING DEVELOPMENT AGENCY, MURFREESBORO, TENN.

Mr. HAYNES. Mr. Chairman, Senator Durenberger, I am appearing on behalf of the Tennessee Housing Development Agency, and as a past president of the National Lumber and Building Materials Dealers Association with over 30 years experience in the operation of an independent retail building material center which I founded in 1951. As a result of these and other experiences, I have had a unique opportunity to observe housing bonds from several viewpoints.

The sale of mortgage revenue bonds in Tennessee in recent years has had a significant positive economic and fiscal impact on local, State and Federal Governments.

The Tennessee Housing Development Agency has now sold $485 million in mortgage revenue bonds, generating economic effects which include the following: increased jobs in all phases of the construction industries that supply construction; and increased sales and receipts for wholesalers, contractors, builders, and professional service firms. The fiscal effect of these bond sales include: increased payment of Federal personal and corporate income taxes; increased payment of State sales and privilege taxes; and increased payment of local property taxes.

These economic and fiscal effects are in addition to the primary benefit of providing affordable housing opportunities to thousands of low- and moderate-income families in our State who are not traditionally served by the private sector.

Many of these families would not have otherwise been able to own their own home and would have become a burden on public housing or other subsidized programs.

The inability of housing finance agencies to sell bonds has been a major contributing factor to the extremely low volume of 1981 housing starts in our country.

During 1979 and 1980, about $9.5 billion in housing bonds were issued each year to finance the purchase of single-family homes for low- and moderate-income families and, by this time last year, over $8 billion of these bonds had been issued. However, so far this year, the total is virtually zero, even though the combined allocation permitted by the Mortgage Subsidy Bond Tax Act for all States totaled approximately $15 billion. This would finance the purchase of approximately 300,000 homes, new and existing, after the price restrictions under the new act are applied.

The total impact of bond-financed loans on the housing industry will be even greater than the numbers indicate because many of these loans will be used to finance a sale of low priced existing homes, releasing the equity that has accumulated by the present owner. This equity, in turn, will be used to purchase a better used home, or a new home, thereby increasing the sale of homes in all price categories.

The very large dollar volume of equity released from the sale of existing homes is often overlooked by economists and its effects on the housing industry have been underestimated.

Recognizing the importance of housing bonds to our State, our agency has made a determined, but thus far unsuccessful, effort to issue bonds under the severe restrictions placed on such an issue by the Mortgage Subsidy Bond Tax Act of 1980.

On April 16 of this year our agency made application to IRS for a ruling on a proposed plan of financing.

To give you some idea of the complexities of trying to meet the requirements of these new Federal regulations, I would like to show you my copy of this application, which measures 2½ inches thick. This does not include over a half inch of additional material that has been requested by IRS. Quite a document.

Senator PACKWOOD. Mr. Haynes, let me ask you this again. I have read your statement. It is helpful to us if you don't just read right through the statement that we have read because we are trying to keep our witnesses within the time limit and finish up our panels this morning.

Mr. HAYNES. Thank you. I submit that these new Federal regulations represent a classic example of over-regulation on the part of the Federal Government. To control the use of housing bonds, all that was necessary was a simple bill that would establish an allocation for each State and define who would be eligible to participate, and leave the implementation details to the individual States. Such a bill was introduced last fall by Senator Sasser, but, unfortunately, it was not enacted.

I would like to further point out that the additional cost for complying with these new and unnecessary regulations are passed along to the home buyer in the form of higher interest rates, even though the subsidy cost to the Federal Government remains exactly the same. By the way, this subsidy cost will now be significantly reduced because the maximum tax bracket has been reduced to 50 percent.

Pursuing our efforts to issue bonds, we were advised by IRS the first week in August that they had started work on our application which culminated in a hearing in their office here in Washington on September 2. At the hearing, the IRS was able to clarify many of the regulations that were issued in June.

Senator PACKWOOD. I am sorry to interrupt you, but we will have to go on to the next witness.

Mr. HAYNES. Thank you.

Senator PACKWOOD. Thank you.

Let me say again to the witnesses, I have read these statements. And it does not serve your purpose nor ours to simply read through the exact statement. Emphasize the point you want to make and accept the fact that it is a topic that Dave and I know something about. And it would be most helpful to us if you emphasize your major point.

Mr. HAYNES. Mr. Chairman, I would say I reduced that by about 50 percent of what I had prepared. [Laughter.]

I would like to add though that I have our bond counsel attorney, Mr. Paul DeBerry, with me, who is chiefly responsible for the language in the Senate bill S. 1348. He would be available to answer any technical questions that might come up to the committee here.

Senator PACKWOOD. Thank you very much. Again, I appreciate each of you witnesses commenting on registration. I would almost be willing to take any witness from the audience that says that registration doesn't cost anything if there is anybody in the audience who would say that.

Mr. Dinerstein.

STATEMENT OF JAMES DINERSTEIN, SPECIAL ASSISTANT ATTORNEY GENERAL AND COUNSEL TO THE MINNESOTA HOUSING FINANCE AGENCY, ST. PAUL, MINN.

Mr. DINERSTEIN. Mr. Chairman and Senator Durenberger, my name is James Dinerstein. I am a special assistant attorney general for the State of Minnesota and serve as counsel to the Minnesota Housing Finance Agency. I greatly appreciate the opportunity to appear before you today to discuss the proposed amendments to the Mortgage Subsidy Bond Tax Act of 1980 as they appear in S. 1656. I have submitted to the committee the written testimony of James Solem, executive director of the Minnesota Housing Finance Agency. Mr. Solem's presentation provides a detailed analysis of the provisions of S. 1656. This morning I would like to elaborate on a few of the points made by Mr. Solem in his presentation.

[The prepared statement of Mr. Solem follows:]

MINNESOTA
HOUSING
FINANCE
AGENCY

TESTIMONY SUBMITTED BY
JAMES J. SOLEM, EXECUTIVE DIRECTOR
MINNESOTA HOUSING FINANCE AGENCY
BEFORE THE FINANCE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT
OF THE UNITED STATES
SENATE COMMITTEE ON FINANCE

HEARING OF
OCTOBER 16, 1981

PRESENTED BY:

JAMES E. DINERSTEIN
SPECIAL ASSISTANT ATTORNEY GENERAL

333 Sibley Street, St. Paul, Minnesota 55101 (612) 296-7608
Equal Opportunity Housing and Equal Opportunity Employment

SUMMARY

1. The Minnesota Housing Finance Agency believes that the passage of S. 1656 is necessary in order to permit the issuance of qualified mortgage bonds under the Mortgage Subsidy Bond Tax Act of 1980. MHFA believes that its past experience demonstrates that it is possible to develop and operate responsible programs using mortgage bonds to provide housing to low and moderate income people.

2. The most critical amendment to the Mortgage Subsidy Bond Tax Act of 1980 is the modification of the 95% requirement in Section 103A(c)(2)(B).

3. The second most important amendment to the Act is the change in the permitted yield to the issuer to 1.25 percent.

4. The amendments to protect the issuer from a forced sale of investments at a loss and to lift the registration requirement are necessary to permit the issuance of mortgage subsidy bonds.

5. The amendment to 103(b)(4)(A) is necessary in order to conform the changes in the law affecting multi-family rental housing to the realities of the marketplace regarding the term of mortgage loans and bonds used to finance multi-family housing.

Mr. Chairman and Members of the Committee:

Thank you for this opportunity to present material to you in support of S. 1656, authored by Senator David F. Durenberger, the senior senator from Minnesota. We would also like to thank Senator Durenberger, once again, for the invaluable assistance he has given us since his election to the U. S. Senate. Introduction of this bill by Senator Durenberger represents the culmination of several years of sustained effort to ensure that the housing needs of low and moderate income people are met through a continuing partnership between the public and private sectors and among all levels of government. Mortgage revenue bonds symbolize this partnership.

The use of mortgage revenue bonds has enabled state and local units of government, in close cooperation with the investment and lending industry, to serve thousands of lower income families who would not otherwise have been able to afford decent housing. Yet now, when the housing industry is facing its worst crisis in fifty years, we at the state level are powerless to help, because we have been inadvertently deprived of the use of our primary financing tool - mortgage revenue bonds. Unless S. 1656 is adopted, most non-federal housing programs (and some federally sponsored programs, as well,) will come to a halt. The Mortgage Subsidy Bond Tax Act of 1980 will become known as the Mortgage Subsidy Bond Tax Moratorium.

Before we begin a detailed analysis of the provisions of S. 1656, we would like to briefly describe the programs of the Minnesota Housing Finance Agency (MHFA) and the clientele we have served.

MHFA was created by the State Legislature in 1971 to help improve the quality of the state's housing stock and enable low and moderate income people to afford housing that is decent, safe and sanitary. During the first decade of its existence, MHFA has helped over 70,000 families through a wide variety of programs in the areas of home purchase, home improvement, energy conservation, rental housing construction and rehabilitation, and group homes for the developmentally disabled. Almost $150,000,000 have been appropriated by the Minnesota Legislature for use, either alone or in conjunction with mortgage revenue bonds, to help population groups with special needs such as the elderly, the handicapped, first time home buyers, Vietnam era veterans and American Indians.

Since 1973, over 11,500 households have received bond financed first mortgage loans to purchase a home. Since 1978, over one-third of the borrowers have received downpayment assistance or monthly assistance financed with state appropriations. Program guidelines have been designed to ensure that benefits are targeted to people of limited means for the purchase of modest housing.

Demographic data on loan recipients indicate that these efforts have been successful. Under the MHFA 1980 Home Mortgage Loan Program, borrowers had an average gross annual income of $17,187. The average mortgage was $40,027 on a home selling for an average price of $43,552, yielding an average loan to value ratio of 92%. Eighty-eight percent of the borrowers were first time homebuyers and 42% of the homes were newly constructed.

Another MHFA program which relies on the sale of tax exempt revenue bonds is the Home Improvement Loan Program. Minnesota was the first State in the nation to develop a home improvement loan program. By combining bond proceeds with state appropriations, MHFA has been able to provide loans to families of up to $18,000 annual income at income-adjusted interest rates ranging from 1-8%. As of June 30, 1981, MHFA had pooled $30 million in state appropriations with $139 million in bond proceeds to provide 31,700 loans. During 1980 and 1981, borrowers had an average adjusted annual income of approximately $10,000. They borrowed an average of $5,740 at an average 5.5% interest rate to improve a home with an average age of 51 years. Over half of the homes were built before 1930 and more than 70% received energy conservation improvements.

As the above summary indicates, the State of Minnesota has demonstrated a very strong commitment to serving the housing needs of its lower income residents. It has successfully combined federal resources (Section 8 Housing Assistance Payments and various insurance programs) with state revenues and private capital to help people of modest means obtain decent and affordable housing. It has improved the quality of the existing housing stock, recycled and rehabilitated vacant or deteriorating structures and increased the supply of new housing. It has promoted residential energy conservation through home improvement grants and loans and the financing of highly energy efficient new construction. It has served urban, suburban and rural areas through a network of 300 lenders and 70 grant administration centers. It has fostered cooperation with local units of government and local housing authorities in single family and multi-family programs.

Yet the ability of the State of Minnesota to continue to serve the needs of its residents is being severely curtailed by the indirect ban on the sale of tax exempt bonds which results from certain technical provisions of the Mortgage Subsidy Bond Tax Act of 1980 and subsequent misdirected Treasury regulations implementing, and interpreting the Act.

Almost immediately following the passage of the Mortgage Subsidy Bond Tax Act of 1980 (the "Act"), MHFA began an effort to continue to operate its programs for low and moderate income Minnesotans under the restrictions contained in the Act.

The MHFA effort has been divided among two major tasks. The first has been a thorough review of existing MHFA programs to revise the programs so that they might continue to operate under the Act. This task involved an analysis of the Act and, following their issuance, the Temporary Regulations. Based upon this analysis, the Agency proceeded to revise MHFA programs, review relationships with lenders, and prepare bond and mortgage loan documentation. This work by MHFA continues to this day.

The second major task has involved the participation by MHFA staff in a series of meetings between a Council of State Housing Agencies (CSHA) Committee and staff from the IRS and Department of the Treasury in which CSHA sought (1) to explain the manner in which State Agency programs operate, (2) to outline the portions of the Act which CSHA believed required clarification, and (3) to set forth some basic regulatory approaches which would permit the issuance of qualified mortgage bonds under the Act. The CSHA Committee presented to the Treasury and IRS staff only those regulatory issues which CSHA believes are essential to carry out the intent of Congress that bonds be issued under the Act.

MHFA was hopeful that the Regulations issued by the Department of Treasury would provide a workable framework for the issuance of bonds under the Act. The Temporary Regulations issued by the Department of the Treasury in June of this year fell far short of providing this workable framework.

MHFA is here in support of S. 1656 because the bill is necessary in order to permit states to carry out the intent of Congress reflected in the Act. While there may be certain provisions of the Act which need some adjustment and refinement, we are content at this time with technical amendments which will permit us to continue our objective of providing housing for persons and families of low and moderate income.

As described below, some of the provisions of S. 1656 are made necessary because the Department of the Treasury has made it clear in the Temporary Regulations that they do not believe that a workable interpretation of the Act is permitted by the Act and its legislative history.

The following are the MHFA views on the necessity of each of the provisions of S. 1656:

I. Section 1(a). Good Faith Compliance.

The single most important objective of any amendments to the Act is to clarify the 95% requirement in § 103A(c)(2)(B)(ii). The essential element in any modification to this provision is to permit an issuer to correct a loan which is determined to not be in compliance with all of the mortgage eligibility requirements, either by correcting the loan itself or replacing it with a loan or loans which are in compliance with all of the mortgage eligibility requirements.

The need for this provision is most clearly understood when viewed in the context of the operation of a single family program by MHFA.

MHFA operates two types of programs with the proceeds of mortgage bonds. They are the home improvement loan program and the single family mortgage program. In both programs, MHFA purchases eligible, below market interest rate loans originated by approximately 300 lending institutions located throughout the State of Minnesota. These lending institutions vary significantly in the level of sophistication of their loan underwriting staff. Many of the rural lenders who participate in the MHFA home improvement loan program had not previously been in the business of making Title I insured home improvement loans. Similarly, many of our rural lenders who participate in the home mortgage program had no previous experience in originating first mortgage loans for sale in the secondary market.

The 95% requirement applies to the mortgage eligibility requirements under the Act. These are the principal residence requirement, the three year requirement, the purchase price limits, the prohibition against refinancing, and the limitation on assumptions. Except for the limitation on assumptions, the mortgage eligibility requirements all involve the determination of certain facts which the issuer can only obtain by asking questions of other persons. This is much different than the non-mortgage eligibility requirements of the Act, where the relevant facts are all under the control of or generated by the issuer. Most of the facts that must be obtained to determine compliance with the mortgage eligibility requirements must be asked of the borrower. The issuer is at risk if the borrower does not tell the truth. In addition, anyone who has obtained mortgage financing to purchase a house is aware that it is a very confusing process, particularly for a first time homebuyer of low and moderate income. The borrower will be presented with numerous complex documents which must be completed and executed. There is a very real possibility that errors will be made in verifying compliance with program requirements, even where there is no fraud on the part of the borrower, especially where the originating lending institution does not have a sophisticated, experienced loan underwriting staff. Under the Temporary Regulations, if a mortgage did not meet every requirement when originally purchased, for whatever reason, it cannot be corrected for the purposes of the 95% requirement.

The Department of the Treasury stated in the supplementary information preceeding the Temporary Regulations that "the 5 percent margin for nonqualifying mortgages protects the issuer from inadvertent error or mortgagor fraud." This is simply not true. The existence of a 5 percent margin is of little comfort to the bond holder when it is necessary to rely upon the honesty or accuracy of the borrower to protect the tax-exempt status of the bond holder's investment.

While the precise language of section 1(a) of S. 1656 needs some fine tuning, the basic approach is sound. A loan would not be counted against the 95% standard so long as correction is occuring (resulting within a reasonable time in either the correction of the loan itself or replacement with a qualifying loan). In addition, there will be audits performed. Evidence of fraud or other criminal acts will be referred to the appropriate authorities for prosecution.

The notion of replacement with a qualifying loan perhaps merits further explanation. The House Committee Report on H.R. 5741 (Report No. 96-678) on page 36 endorses this concept. Where a mortgage can be corrected, the issuer will proceed to do so. In many cases, correction of the mortgage itself will not be possible. For example, if the borrower did not meet the three year requirement, the mortgage is not correctable. The issuer may then call the loan, particularly where there is evidence of fraud. Where there is no fraud, but merely inadvertent error, the issuer may choose to purchase the loan from other funds available to it and use the proceeds to make a new, qualifying loan. Thus, the issuer will have a loan as an investment, which although not "qualified" is otherwise a perfectly good loan, and the issuer will not be required to foreclose a loan on an honest low and moderate income family who could not afford to pay the cost of a market rate mortgage loan. Where the loan is unqualified as a result of error by the originating lender, the issuer may make the lender repurchase the loan.

The 95% requirement is the principal impediment to the issuance of qualified mortgage bonds. Prior to the publication by the Department of the Treasury of the Temporary Regulations, MHFA had marketed approximately $28,000,000 in bonds for its home improvement loan program. Since the regulations were published prior to closing of the sale, the purchasers were given the option to cancel their orders after review of the regulations. More than half of the purchasers exercised this option to cancel their orders after review of the regulations.

II. Section 1(b). Increase in Amount of Mortgage Interest Limitation.

Prior to the Mortgage Subsidy Bond Tax Act of 1980, the effective mortgage interest rate on loans made with the proceeds of tax exempt bonds could exceed the bond yield by 1 1/2 percent to pay for administrative costs. In addition, earnings from non-loan investments were available to reimburse the issuer for expenses.

The Act reduced the permitted spread from 1 1/2 percent to 1 percent. The apparant 1/2 percent reduction is actually more than a 1 percent reduction due to the change in definitions of effective mortgage interest rate and the bond yield. The two major changes in definitions relate to the method of recovery of the issuer's cost of issuance and the method of calculating the effective mortgage interest rate. The change in the bond yield was that, under the Act, the issuer may no longer recover costs of issuance outside the permitted spread. The change in calculating the interest rate is to compound prepayments of principal on loans on a monthly rather than semiannual basis. The later change in definition was not a result of the law, but is based upon Treasury Regulations which ignored the conference report directive and prior industry practice.

The permitted 1 percent spread is not adequate to cover the costs of issuing and retiring bonds and originating and servicing mortgage loans and to provide, in addition, sufficient revenues to support the issuer's costs of fulfilling its fiduciary responsibilities of managing the program during the life of the bond issue and to provide adequate reserves to protect the issuer and bondholder from unexpected loan losses, fluctuations in loan prepayments, and changes in short term investment rates.

The spread of 1 1/4 percent permitted in S. 1656 will allow the issuer to recover a reasonable amount of costs and will still require the issuer to reduce the costs of the issue below those allowed prior to the Act.

The 1/4 percent increase permitted in S. 1656 will either not change or will decrease the interest rate on the mortgage to the homebuyer. The higher bond rating, which can be obtained from rating agencies on the issue, will reduce the interest rate paid to the bond buyer. This savings would be passed on to the homebuyer. The 1/4 percent increase will not affect the Federal budget.

III. Section 1(c). Disposition of Non-Mortgage Investments.

The Temporary Regulations place the issuer in an untenable situation with respect to the investment of its reserves. If the issuer places its reserves in short term investments to avoid the risk of loss due to sale of the investment before maturity, it will incur the risk that short term rates will fall below the bond yield at the time the reinvestment of the reserves takes place. Based upon past experience, it is very likely that at various times during the life of the issue, short term taxable rates will be below the long term yield on the bonds.

On the other hand, if the issuer places the reserves in longer term investments based upon the expected prepayment of mortgages, the regulations would force the issuer to sell the investments if prepayments of mortgages are more rapid than anticipated, regardless of the loss due to their sale prior to maturity.

The primary concern of MHFA is the investments in the debt service reserve fund. The maturity of these investments is based upon the estimated prepayments of mortgages, since the aggregate amount of non-mortgage investments must promptly and appropriately be reduced as mortgages are repaid. Although the Act requires the issuer to make certain assumptions regarding the prepayment of mortgage loans for the purpose of yield calculations, it is unlikely that these assumptions will turn out to be correct. The issuer does not know how fast and when mortgages will prepay. If the mortgages prepay faster than estimated, the current law would require the sale of investments at a loss in order to reduce the aggregate amount of non-mortgage investments. If the mortgages prepay more slowly than estimated, there is a risk that the rate on a new investment will be lower than the bond rate.

The 1 1/4 percent spread between the effective mortgage interest rate and the bond yield permitted by S. 1656 is not sufficient to reimburse the issuer for its losses due to these risks.

IV. Section 1(d) - Elimination of Registration Requirements.

The requirement that qualified mortgage bonds be registered after January 1, 1982 is an unfair burden on the issuer of these bonds. The purpose of the Act was to limit the volume of qualified mortgage bonds and to limit their use to a socially acceptable purpose. This having been accomplished there is nothing to be gained by treating them in a manner different from all other tax-exempt issues.

V. Section 2. Rental Property.

The amendment to 103(b)(4)(A) is necessary to permit a reasonable range of alternative methods of providing rental housing for low and moderate income families. The language of the Act narrowly restricts the use of tax exempt bonds to developments operated in the same manner as the Section 8 new construction and substantial rehabilitation programs. The language of the Act is so narrow that it is not even possible to issue bonds to finance developments subsidized under the Section 8 moderate rehabilitation program.

The principal source of the difficulty is the requirement under §§ 1103(a) and 1104(k) of the Act that there be a 20 year period during which at least 20% of the units in the development (15% in target areas) are held for individuals of low and moderate income. Although the Department of the Treasury has yet to issue regulations implementing the multi-family rental portions of the Act, it is difficult to see how the regulatory process will be able to remedy this problem. The difficulty is that a twenty year period is unrealistic for most forms of bond financed developments. The 20 year period is based upon the Section 8 new construction and substantial rehabilitation program, which provides a unique long term federal subsidy for rental housing. Without a similar subsidy, an equivalent long term commitment may not be practical. In addition, a 20 year term may exceed the life of bonds issued to finance a development, or the life of the mortgage loan. That is the difficulty with bonds issued to finance improvements under the Section 8 moderate rehabilitation loan program, which has a subsidy term of 15 years, with a resulting 15 year bond life and mortgage loan term.

The approach used in S. 1656 would prohibit the principal anticipated abuse of using tax-exempt construction financing for a short occupancy period followed by conversion to another use. The 10 year minimum term is an adequate method to prevent this abuse.

The second clarification made in the bill is to provide a direct statement of Congressional intent regarding the meaning of the term "individual of low and moderate income" rather than relying on an indirect reference through Section 167(k)(3)(B). This protects against amendments to definitions in the Section 8 assistance program (referred to in Section 167(k)(3)(B)) which would change the scope of Section 103(b)(4)(A). Such changes in the Section 8 program already have occurred in the 1981 Housing and Community Development Act amendments.

In summary, the existing version of the Act and the Regulations have a financial impact on all parties involved in an issue of qualified mortgage bonds. As an issuer of bonds, the Minnesota Housing Finance Agency is, of course, concerned about costs to the Agency as well as its ability to market its bonds. Of greater importance are the increased costs to the borrower, the participating lender, and the state and Federal governments.

The borrower will pay increased costs for two reasons. The first is that the financial restraints in the arbitrage provisions will adversely affect the security of the issue, which will result in higher costs to the issuer which must be passed on to the borrower. The cost of the regulatory approach to the mortgage eligibility requirements (including the 95% rule) found in the regulations will have an even greater impact on borrowing costs. MHFA understands that there are some increased costs inherent in the provisions of the Act itself. However, there are significant cost implications due solely to the regulations. Assuming that bonds can be marketed at all with the mortgage eligibility requirements as written (an assumption which has been questioned by many responsible members of the industry) there will be an interest penalty on the bonds as a result of the potential taxability of the issue. For a moderate income borrower purchasing a $65,000 home (with a 5% downpayment) an increased interest rate of only .5% will cost the borrower $288 a year.

The mortgage eligibility requirements as established in the regulations will create unnecessary burdens on the lenders which originate loans under MHFA's programs. MHFA works through over 300 lenders throughout the State of Minnesota. Many of these are small rural banks with limited staff. The arbitrage yield restrictions limit the amount which can be paid to banks for originating loans. The remaining costs must be absorbed by the banks or by MHFA. Perhaps even more important than the cost involved is that there is no rational explanation for the additional work required by the regulations. For the lenders it is another example of needlessly burdensome regulations by the Federal government.

The regulations will increase costs for the State of Minnesota. The legislature has regularly appropriated money to the Minnesota Housing Finance Agency to write down the interest rate on home improvement loans and to make downpayment and monthly payment assistance to borrowers who purchase residences. The home improvement program is particularly important, and vital at this time, in an energy-poor state like Minnesota with a high proportion of elderly residents. The increased cost of money raised through bonds under the regulations will require additional funds to serve the same population, or will reduce the number of people served by the limited dollars available. In addition, money previously appropriated to aid individual borrowers will have to be used as contributions from the issuer to make the issue feasible under the arbitrage regulations.

Finally, the increase in the interest rates on the bonds caused solely by the regulations will unnecessarily increase the revenue loss to the Federal government as a result of the tax exempt income to the bond holders from the issue.

Mr. DINERSTEIN. Before I begin my discussion of the bill, I would like to point out to the committee that the Minnesota Housing Finance Agency does not object to limitations on the use of tax exempt financing for housing. The Minnesota Legislature placed similar limitations, both on the Minnesota Housing Financing Agency and on local units of government several years ago. While the Minnesota Housing Finance Agency believes that certain portions of the Mortgage Subsidy Bond Tax Act of 1980 require some adjustment and fine tuning, we endorse the basic purpose of the act.

I believe I have a unique prospective to provide to the committee. The Minnesota Housing Finance Agency runs a wide range of programs with a fairly limited staff. As a result, in my legal work for the agency I provide legal advice to the agency board, work with the development of new programs and the preparation and sale of bond issues, and work with the day-to-day legal problems of the agency.

The agency has been attempting to modify its programs to comply with the restrictions of the act for the last 10 months. The agency does not believe that the act as interpreted by the temporary regulations of the Department of the Treasury is workable. The two most critical amendments to the act are the 95-percent requirement and the increase in the permitted spread from 1 to 1¼ percent. I will first discuss the 95 percent requirement. Almost all of the mortgage eligibility requirements to which the 95 percent will apply involve the determination of facts which the issuer can only obtain by asking questions of other persons. Most of the facts that must be obtained must be asked of the borrower. The issuer is at risk if the borrower does not tell the truth. An even greater risk for the issuer is inadvertent error on the part of the borrower.

For me, the purchase of my first house was one of the most significant events of my life. It is the greatest single investment that I have ever made, and in many ways symbolized to me that I was permanently entering the adult world. I found my first home purchase to be a more frightening event than either getting married or having children. [Laughter.]

Even though I am an attorney and regularly close multifamily housing loans, I doubt that I understood more than one-third of the documents which passed before me during the processing of my own mortgage loan. If that was the case when I purchased my home, I can imagine that the confusion will be even greater for low income families working with inexperienced lenders.

Under the act, as interpreted by the regulations, the bondholder may face loss of the tax exempt status of the bonds if too many of the borrowers do not understand the requirements of the act or if the borrowers do not tell the truth. It is not much additional comfort to the bondholder to know that the lending institutions may provide an independent investigation of the borrower's certifications. The mortgage eligibility requirements are not easy to understand either for the borrower or the lender. The risk of inadvertent error is quite real.

Does this mean that every issue will have more than 5 percent bad loans? Of course not. But this is of little comfort to a bondholder.

The central problem with the regulations is that even if 100 percent of the loans are corrected or replaced, any loan which does not qualify even for a moment over the life of the issue counts as a bad loan. It is not clear what purpose is to be served by this interpretation. Perhaps the Department of the Treasury believes that the issuer will be sufficiently terrified about the possibility of taxability of the bonds that he will be more diligent in checking the loans. This is not true. The good faith requirement alone imposes a requirement of diligence on the issuer. Unfortunately, this Treasury interpretation has had a very terrifying effect upon the investment community. The alternative provided in S. 1656 will provide every bit as much protection to Congress that its intent is being carried out while providing a much more workable framework under which housing finance agencies can operate.

I would also like to briefly address the question of the increase in the permitted spread between the effective mortgage interest rates and the bond yield to 1¼ percent. The most important thing I would like to say about that is that because of the change in definitions the yield that issuers used to be able to have was closer to 2 percent, so that the act has increased cost and reduced the yield by more than a half.

Mr. Smith discussed the effect of the increase in cost of an issue as a result of registration. Perhaps more important, a low income borrower buying a $65,000 house with a 5-percent down payment would pay $288 each year in addition with a 50-basis-point increase in the rate on the bonds.

Had time permitted, I would have liked to have addressed the remaining provisions of the Durenberger bill all of which are essential. However, I appreciate your time and will be glad to answer any questions that you may have, and also to provide some technical provisions that I have drafted to the committee staff. Thank you very much.

TESTIMONY OF JAMES E. DINERSTEIN, SPECIAL ASSISTANT ATTORNEY GENERAL, COUNSEL, MINNESOTA HOUSING FINANCE AGENCY

Mr. Chairman and Members of the Committee, my name is James E. Dinerstein. I am a Special Assistant Attorney General for the State of Minnesota and serve as Counsel to the Minnesota Housing Finance Agency. I greatly appreciate the opportunity to appear before you today to discuss the proposed amendments to the Mortgage Subsidy Bond Tax Act of 1980 as they appear in S. 1656, authored by Senator Durenberger of Minnesota. I have submitted to the Committee the written testimony of James J. Solem, Executive Director of the Minnesota Housing Finance Agency. Mr. Solem's presentation provides a detailed analysis of the provisions of S. 1656. This morning, I would like to elaborate on a few of the points made by Mr. Solem in his presentation.

Before I begin my discussion of the bill, I would like to point out to the Committee that the Minnesota Housing Finance Agency does not object to limitations on the use of tax exempt financing for housing. The Minnesota legislature placed similar limitations both on Minnesota Housing Finance Agency and on local units of government several years ago. While the Minnesota Housing Finance Agency believes that certain portions of the Mortgage Subsidy Bond Tax Act of 1980 require some adjustment and fine tuning we endorse the basic purpose of the Act.

I believe I have a unique perspective to provide to the Committee. The Minnesota Housing Finance Agency runs a wide range of programs with a fairly limited staff. As a result, in my legal work for the Agency I provide legal advice to the Agency Board, work with the development of new programs and with the preparation and sale of bond issues, and work on the day to day legal problems of the Agency's programs. I have worked with Bond Counsel, Agency staff, and local lenders in the Agency's efforts to make its programs work under the restrictions of the Act.

The Agency has been attempting to modify its programs to comply with the restrictions of the Act for the last 10 months. The Agency does not believe that the Act, as interpreted by the temporary regulations of the Department of the Treasury, is workable.

The two most critical amendments to the Act are the 95 percent requirement and the increase in the permitted spread from one percent to one and a quarter percent. I will first discuss the 95 percent requirement. The Minnesota Housing Finance Agency operates its programs by purchasing loans originated by over 300 lending institutions located throughout the State of Minnesota. These lending institutions vary significantly in the level of sophistication of their loan underwriting staff. Many of the rural lenders who participate in the MHFA programs have very limited experience in loan underwriting and almost no previous experience in preparing loans for sale in the secondary market. Almost all of the mortgage eligibility requirements to which the 95 percent rule applies involved determination of facts which the issuer can only obtain by asking questions of other persons. Most of the facts that must be obtained must be asked of the borrower. The issuer is at risk if the borrower does not tell the truth. An even greater risk for the issuer is inadvertent error on the part of the borrower.

For me, the purchase of my first house was one of the most significant events of my life. It is the greatest single investment that I have ever made, and in many ways symbolized to me that I was permanently entering the adult world. I found my first home purchase to be a more frightening event than either getting married or having children. Even though I am an attorney, I doubt that I understood more than one-third of the documents which passed before me during the processing of my mortgage loan. If that was the case when I purchased my home, I can imagine that the confusion will be even greater for low income families working with inexperienced lenders. Under the Act as interpreted by the regulations, the bondholder may face loss of the tax exempt status of the bonds if too many of the borrowers do not understand the requirements of the Act, or if the borrowers do not tell the truth. It is not much additional comfort to the bondholder to know that the lending institution may provide an independent investigation of the borrower's certifications. The mortgage eligibility requirements are not easy to understand either for the borrower or the lender. The risk of inadvertent error is quite real.

Does this mean that every issue will have more than 5 percent bad loans? Of course not, but this is of little comfort to a bondholder. The central problem with the regulations is that even if 100 percent of the loans are corrected or replaced, any loan which did not qualify, even for a moment, over the life of the issue, counts as a bad loan. It is not clear what purpose is served by this interpretation. Perhaps the Department of the Treasury believes that the issuer will be sufficiently terrified about the possible taxability of the bonds, that it will be more diligent in checking the loans. This is not true. The good faith requirement, alone, imposes a requirement of diligence on the issuer. Unfortunately, this Treasury interpretation has had a very terrifying effect upon the investment community. The alternative provided in S. 1656 will provide every bit as much protection to Congress that its intent is being carried out, while providing a much more workable framework under which housing finance agencies can operate.

I would also like to briefly address the question of the increase of the permitted spread between the effective mortgage interest rates and the bond yield to one and a quarter percent. The most important fact to bear in mind in considering this increase, is that the Mortgage Subsidy Bond Tax Act of 1980 did not simply reduce the permitted spread from one and a half to one percent. The Act, and the subsequent regulations, have made significant changes in the definition of terms. While it may be true that previous regulations permitted only a one and a half percent spread to the issuer, if you use the definitions in the Act and regulations you will find that prior to the Act, the effective spread was closer to two percent. In essence, the Act has increased the administrative cost to the Agency while cutting

Had time permitted, I would have liked to have addressed the remaining provisions of the Durenberger bill, as well as to discuss certain technical revisions which I would propose for the bill. However, I appreciate your time and will be glad both to provide the technical revisions to committee staff and to answer any questions you may have.

Senator PACKWOOD. I will make you a bet that Senator Durenberger will phrase his questions in such a way that you get to bring out the additional points of the Durenberger bill. [Laughter.]

Mr. Helmbrecht.

STATEMENT OF RICHARD K. HELMBRECHT, PRESIDENT, COUNCIL OF STATE HOUSING AGENCIES, WASHINGTON, D.C.

Mr. HELMBRECHT. Mr. Chairman and Senator Durenberger, I am Richard K. Helmbrecht, president of the Council of State Housing Agencies, executive director of the Michigan State Housing Development Authority and a member of the President's Commission on Housing. In my capacity here this morning, I am representing the former two organizations, not necessarily the latter.

State housing agencies have successfully administered housing programs for years, but since the introduction of the Mortgage Subsidy Bond Act I and other housing professionals have spent our energies and thousands of hours of trying to make sense out of that legislation. Our goal now is simple: We are trying to make the legislation work. The President's budget already envisions a program that works. Thus, the expenditure for the program has been taken into account. Moreover, we do not seek to expand the use of tax exempt bonds either through S. 1348 or through any changes in the rules and regulations issued by Treasury. All we wish to do is get housing moving again by providing affordable financing to a qualified American home buyer, homeowner and renter.

It is estimated that if we could move the restrictions that now exist in the tax exempt housing area, over the next 12 months we could provide financing for approximately 180,000 first-time home buyers and trigger the additional sale of some 400,000 units. In the process, some $2 billion in tax revenues would be generated, and some 300,000 jobs.

The central elements in which we need relief are simple and have been mentioned here this morning. The industry agrees that we need relief from what is known as the 95-percent rule. The act and the regulations, combined, requires bond counsel to give a qualified opinion on the tax exempt nature of any bonds issued under the act. A qualified opinion makes bonds difficult, and in this market, impossible to sell.

The relief we need must also result in an unqualified bond opinion. The industry agrees to the need for relief from arbitrage and yield restrictions. No other issue causes more furor. Many oppose changes in arbitrage to avoid alleged abuses, large fees and agency enrichment. We must emphasize that we run responsible programs targeted by our legislators to low and moderate income families otherwise priced out of the housing market. The present 1-percent limitation in the act is really about a 0.5-percent limitation, because underwriter fees, bond counsel fees and other costs of issuance presently included in the 1-percent limit were not included in the 1.5 percent. Thus, the restrictions are increasingly tight and Treasury regulations require more extensive administration than previously existed with less fees and expenses.

For example, in our single-family program in Michigan, where we used to have a 1-page list of instructions and two requirements, namely, a mortgage limit and an income limit, now in working out and trying to attempt to implement the Mortgage Subsidy Bond Act, we have a 15-page, legal size, handout for the servicers of the program.

We have seen legislation this year that authorizes other financial institutions to create tax-exempt funds without any restrictions on whom may be served with the proceeds and without any yield limitations. Yet, when we ask for a one-fourth or a one-half percent for targeted—and I emphasize targeted—housing programs, we are accused of being irresponsible. We only ask for sufficient leeway to make the programs workable for all States, not only the few who may have the ability to obtain cash contributions, but rather all States, including many new housing finance agencies that have been established in the past year or two.

Finally, we need clarification on the multifamily provisions of the law. We painfully recognize the Treasury's enthusiasm for the use of tax exempt revenue bonds is well under control. Nowhere has this regulatory theater of the absurd been more clear than in the multifamily area. This was a minor yet potentially crippling part of the act. Yet, nearly 1 year after the act was passed, there are no rules or regulations yet available.

Our written testimony suggests some simple solutions—at least we regard them as simple—and, by comparison, they are immensely simple, which will help clarify this area of the legislation.

Above all else, State agencies—and we believe the entire industry—wishes to get going again and provide affordable housing to the American public. We are willing to accept, and indeed we encourage, minimal changes to make the legislation workable. Again, we are not asking for the extension or expansion of the use of tax-exempt bonds. These changes will have little or no budget impact.

You can act to give local and State government a successful program and allow it to reinstitute a successful program. All we ask is that you act quickly. Thank you.

Senator PACKWOOD. Thank you. Senator Durenberger?

Senator DURENBERGER. Thank you, Mr. Chairman. Dick, let me ask you a couple of questions—I am picking on you because you are currently president of the council, not just because you come from Michigan—about the arbitrage issue. And I think you, to a degree, covered them both in your opening statement. But I am told that Buck, when he was here earlier, repeated something that I think I have heard before somewhere, and that is that it was the intent of Congress to force local issuers to put up some of the money to allow the issuance of bonds. And I heard you say something about all States versus States either with capacity or commitment. And I wonder if you might either restate that or expand on that notion. It is not my impression that it was the intent of Congress. It might have been the intent of some individual Congressman or woman. But would you deal briefly with that issue?

Mr. HELMBRECHT. Certainly, Senator. Senator Durenberger, having lived with the issue for some time, I realize or recognize that the discussion did take place within the Ways and Means Committee. It was the opinion or view of a number of the members of the committee that there should be some local contribution or some issuer contribution made. It was never my impression that it was the intent of the committee, or indeed the intent of the legislation that a contribution would be made.

As it stands now, the 1-percent restriction has been drawn so tightly, not only in terms of the actual 1 percent itself, but in terms of what it disallows; that it would be impossible for any State to issue without making a substantial cash contribution up front to make the program work.

Senator DURENBERGER. And that gets us to the problem of capacity and priorities in the varying States.

Mr. HELMBRECHT. Yes. Traditionally, State finance agencies of this nature—housing agencies—have been set up to operate on their own. Michigan, Minnesota, I believe Oregon, often have the State contribution as part of it for specific programs. In Michigan, for example, $20-some million has been put in to write down home improvement loans so that we can leverage more bond dollars. But none of the money has been directed toward the issuance of the bond itself. But the intent has always been that the agency would operate through its own fees and charges and would not be a general fund expenditure of the State; that if the State legislature determined that it wanted to leverage a program or increase a program, or, for example, issue, as we do in a limited program in Michigan, forgivable loans, then the State legislature could indeed do that. But it was not a product of the agency itself. It was to operate autonomously in terms of its fees and charges and, therefore, many of the new State housing finance agencies that have been established do not have any reserves, if that were indeed a requirement, do not have any reserves to put toward an issuance of this nature.

Senator **Durenberger**. Let me ask you next to deal with the spread issue, and, more particularly I guess, the issue of the allowable expenses that are no longer allowable. You referred to a couple of them. But it might help the record here, if we can get Treasury to read it, if you would be perhaps more precise or more specific about the formerly excluded costs that are now made part of the 1 percent.

Mr. **Helmbrecht**. Sure. Under the previous position, under the 1.5 provision which we operated for many years, the expenses for bond counsel fees, for underwriter fees, and other issuing expenses, trustee expenses, et cetera, were not included in that 1.5 percent. These will vary, arranged in accordance to the extent or size of the issue. And, therefore, you could have a range of, say, 0.15 to 0.35 percent in terms of expenses and fees, given the expenses involved, No. 1, the extended issue, the size of the issue itself. These were never concluded previously. Now they are all part of that 1 percent. And when I referred to this as absurdity of regulations, this gets back to another point.

For example, under one point, part of that was a 0.37 service's fee. Most of the State agencies operate through private servicers. I know Minnesota, for example, has some 200 servicers in the program; Michigan operates with about 100 financial institutions—S&L's, banks—that participate in the program.

We asked them to administer the program at 0.37. Now, with a 15-page list of targets that they must administer, we are asking them, under the 1 percent, to reduce that fee from 0.37 to 0.30. Obviously, you are going to have loose administration which gets back to the point of the 95-percent restriction. These things cannot be treated separately as were treated separately by Assistant Secretary Chapoton this morning. They are interlinked, and if you deal with one, you are not necessarily providing a remedy in another field. You might lessen some of the pressure in another field as 95 percent lessening the requirement and enforcing the 95 percent and operating on a good faith basis or something of that nature may lessen some of the fees and charges here of administration. But what you are asking really the private sector to do is administer a program much more intensely at much less return.

Senator **Durenberger**. All right. As you and others know, in order to get the bill in we tried to compromise between 1½ and 1 and ended up, logically, being 1.25, proving we can all count. But you have mentioned that there is a difference between smaller issues and larger issues. Is it impossible or is it possible perhaps to design a sliding scale on this whole arbitrage issue? Or should we make our decision somewhere between 1 and 1.5?

Mr. **Helmbrecht**. I would argue, Senator, for purposes of clarity that you make that decision somewhere in that range. We have provided a backup here with estimated costs, which is the result of input from a number of various agencies, and a basis on similar assumptions that it might range from about a point—0.05 to 0.25—depending on the size of the issue, but expenses would be involved, et cetera. Obviously, it would be easier to keep it at a lower level if you had a larger issue. That is not necessarily the case. Many of the issues that housing finance agencies initiate are tailored to specific programs. Home improvement issues tend to be very small.

Single-family issues, when we could do them, were much larger. So that the expenses do vary. But it was the concensus of the testimony presented here—the backup information presented to the committee—that most issues could operate within the 1.25 range, assuming that the underwriter fees and bond counsel fees were included within that 1.25.

Senator **Durenberger**. Is there any disagreement among the panel of what Dick has said?

[No response.]

Senator **Durenberger**. Jim, can you expand briefly on your suggestion that we need more flexibility in the 95-percent good faith requirement for the inadvertent, noncomplying loans?

Mr. **Dinerstein**. Senator, the important thing about this good faith requirement is that there needs to be some way that agencies can replace bad loans and not just have to call these loans. There are four different kinds of errors you will get with a loan. First, the housing finance agency made a mistake and bought something that they shouldn't have purchased, in which case we should pay the piper for it. Second, if it is a lender error, we can sell it back to the lender. If it is borrower fraud, we can call the loan and attempt to prosecute the borrower, although I caution the committee that Minnesota courts may be sympathetic to the borrower who is going to get kicked out of his house even if he has committed some fraud in the making of the loan.

With most of the errors, they will be inadvertent errors. And I think that the housing finance agency, as a public body, would prefer, where it has funds available to it, to purchase the loan from out of the bond financed portfolio and make a new loan. And in that way, the agency would have a good investment, although it would be at a below market interest rate. And the borrower would not be kicked out into the street, because if we are doing our proper underwriting, these are low income folks who cannot afford to get a loan at market rates.

I would like to, if I may, make one short comment on the appropriations. The Minnesota Legislature has appropriated almost $150 million for programs run by the Minnesota Housing Finance Agency. I think they would view it as a shame if we had to take money away from benefiting low- and moderate-income people, and have to use that money to pay cost of issuance. This money allows the agency to target particular pieces of its programs to the very lowest of the very low income.

Senator **Durenberger**. Thank you very much.

Senator **Packwood**. Senator Bradley?

Senator **Bradley**. Thank you, Mr. Chairman. I would like to ask Mr. Helmbrecht a question about the 95-percent compliance test. What, in your view, has to be done in order to make that a kind of reasonable limitation? A lot of people have argued that it is too unreasonable.

Mr. **Helmbrecht**. It is very unreasonable, Senator Bradley. I think perhaps operating on a good faith basis that in allowing the agency to correct loans—no one wants to get in the business of not doing legitimate loans. We are not here for that—and, therefore, what happens under the present system, the present regulations, is that if 7 years out, 8 years out, an agency's portfolio on a single-family program hits that magic 5 percent, all the bonds become taxable. It seems to me, first of all, that the compliance should be placed up front at the time that the issue is complete, that the bonds are issued, there would be a compliance determination.

Second, if any agency goes back and attempts to correct loans, if there were sins of omission, they go back, and review those and audit those. That would be done on a good faith basis. But it seems to me the compliance issue should be at the time that the issue is completed.

Senator BRADLEY. At the end?

Mr. HELMBRECHT. That is correct.

Senator BRADLEY. What about the State ceilings? Do you think that they limit the expense of the program sufficiently to the Federal Government?

Mr. HELMBRECHT. Well, that's a relative question, Senator Bradley. When you are doing zero, 200 million or 9 percent looks very good. Yes, we are very willing to live with that. In our particular State, if we could do that amount of money at this particular time, we would probably be 45 to 50 percent of the market.

Senator BRADLEY. Do you see any dangers that it would not effectively?

Mr. HELMBRECHT. I cannot, offhand, Senator.

Senator BRADLEY. There are a number of other complicated regulations. Do you think they are really necessary? Is there any way we could cut out some of these papers?

Mr. HELMBRECHT. Well, we have submitted testimony and letters to Treasury, endless letters, and we have submitted backup testimony to the committee this morning. I would only give one example in response to your question, Senator.

Senator BRADLEY. So you have provided for the record a long list of testimony?

Mr. HELMBRECHT. Yes, we have. But I will only provide one example. We took the multitude of recommendations in the act and regulations, as now interpreted, and compared them with the two regulations that we have; namely, a mortgage limitation and an income limitation, and we compared it in terms of public purpose, which is a very major focus in our act as it is in all State housing finance agency acts, to determine what kind of an income profile, what kind of a home buyer, we are reaching with that program. And we reached, under our two limitations, a lower income buyer, more first-time home buyers, without the first-time home buyer restriction, than we were by using the multitude of requirements, the targeting requirements, that are now part of the act.

Senator BRADLEY. You are speaking generally nationwide?

Mr. HELMBRECHT. I am speaking in terms of the Michigan experience.

Senator BRADLEY. How would it be nationwide?

Mr. HELMBRECHT. I think that would be quite similar. There are certain exceptions, such as Alaska, where the housing finance agency is responsible for financing a huge percentage of the State's housing, I would say in the area of 70 to 80 percent. But within the other housing finance agencies, most operate under income mortgage or price restrictions, then thereby limit the market to some form of public purpose, as defined.

Senator **Bradley**. Thank you, Mr. Chairman.

Senator **Packwood**. Gentlemen, let me ask each of you a question. Often in this kind of a subject we will get down to negotiating with the Treasury Department, and we may have some leverage but we cannot get everything we want. If you had to put a priority, one most important thing you would like to get rid of in the act—and repeal is not an answer—what is the most important thing, in your estimation, and let's start with Mr. Helmbrecht, and move that way across the panel?

Mr. **Helmbrecht**. Well, this is called division time. No, I don't think there would be a lot of division among us, Senator. I think that perhaps we would agree on two priorities or three. [Laughter.]

One would be the arbitrage provision which is key, absolutely key to make these work, if you are going to operate on a nationwide basis. And that would be the priority. I am not going to speak for the rest, but I think that many of the newer States, either through local provisions or because of their newness, would find it impossible to operate if there is not some lessening of that 1-percent restriction.

Mr. **McNitt**. Senator, I would have to suggest that the 95-percent rule probably is the strongest impediment on a scale of 10, but you have to look at these others, such as the arbitrage rule, and say if that is not 10, then it is 9.5, and you start running down a scale in that manner.

Senator **Packwood**. I understand that. What I am trying to say is if the Treasury Department says, well, all right, we will accept a $400 to $500 million loss. That's all. Now you decide among the priorities how much comes up to that amount. And I have not yet seen Treasury's breakout as to their estimate of the loss for each of these provisions. That is often what we are faced with.

Mr. **Haynes**. Surely. I would agree that the 95-percent good faith requirement would be the most important by far, because we spent half a day, Paul and I, with IRS going over all of these regulations. And this was the one problem they could not satisfactorily deal with.

We were trying to get an issue for our State with a very substantial front-end subsidy. We were going to get around the arbitrage restriction that way. Of course, we submit that this restriction should be changed and the 1¼-percent proposal would be very satisfactory as far as our agency is concerned.

I would like to add my thoughts to the cost on registration, and I concur with the other witnesses on that issue.

Mr. **Smith**. Mr. Chairman, the issue speaks to two different communities. The arbitrage issue speaks to us as an issuer and our ability to operate a program. The good faith speaks to the bonding community and its willingness to accept our offering. From my personal point of view as an agency administrator, arbitrage is life or death. From the point of view of the financial community, 95 percent is life or death.

Senator **Packwood**. Mr. Dinerstein.

Mr. **Dinerstein**. Coming in here today, I think I would have said it was a close first, but 95 percent is first. Based upon the comments of Mr. Chapoton, maybe after I see his regulations, I might shift it to the question of the arbitrage.

Senator PACKWOOD. Gentlemen, thank you. Any further questions, Dave?

Senator DURENBERGER. No.

Senator PACKWOOD. Bill?

Senator BRADLEY. No.

Senator PACKWOOD. Thank you very much for the good presentation.

[The prepared statements of the presiding panel follow:]

STATE OF NEVADA
DEPARTMENT OF COMMERCE
HOUSING DIVISION
201 SOUTH FALL STREET, ROOM 300
CARSON CITY, NEVADA 89710
(702) 885-4258

Finance Subcommittee on Taxation and Debt Management.

Hearing date: October 16, 1981.

Testimony on S.1348 by the State of Nevada by A. L. McNitt, Jr., Administrator, Nevada Housing Division.

On behalf of Governor List and as an officer of the State of Nevada the following testimony is presented to the Finance Subcommittee on Taxation and Debt Management.

First, the State of Nevada supports the immediate passage of S.1348 as a partial, temporary solution to the inequities unilaterally imposed by Congress on the several states by the Mortgage Subsidy Bond Tax Act of 1980. The more appropriate remedy however is 100% repeal of the act rather than these proposed amendments.

Second, the Governor of the State of Nevada has gone on record that any efforts by the Congress or Executive Branch to tax or regulate municipal finance must be opposed vigorously by the State. The history of such a position goes back into the history of our Constitution. We quote Governor Charles Evans Hughes of New York in his 1910 message to the legislature.

"But the power to tax incomes should not be granted in such terms as to subject to Federal taxation the incomes derived from bonds issued by the State itself or those issued by municipal governments organized under the State's authority. To place the borrowing capacity of the State and of its governmental agencies at the mercy of the Federal taxing powers would be an impediment of the essential rights of the States, which, as its officers, we are bound to defend."

Idaho's Senator Borah replied from the floor to the Governor giving assurances that the apprehensions were unfounded including the following excerpts:

"To construe the proposed amendments so as to enable us (Congress) to tax the instrumentalities of the State would do violence to the rules laid down by the Supreme Court for a hundred years, wrench the whole Constitution from its harmoneous proportions and destroy the object and purpose for which the whole instrument was framed." (parenthesis added)

Also on February 10, 1910 Senator Root of New York wrote to a member of the New York Legislature including excerpts as follows:

"I do not consider that the amendment (16th) in any degree whatever will enlarge the taxing power of the National Government or will have any effect except to relieve the exercise of that taxing power from the requirement that the tax shall be apportioned among the several states. (parenthesis added)

"There was no question in Congress or in the courts or in the country about the taxation of state securities. No one claimed that the inability of the general government to tax them was an evil. The inability to tax them did not arise from the terms of the constitution, but from the fact, being the necessary instruments of carrying on other and sovereign governments, they were not the proper subject of national taxation, and that therefore no provisions of Constitution, however wide the scope of their language, could be held to apply to such securities or to the income from them. Judge Cooley, in his work on "Constitutional Law", says:

'The power to tax whether by the United States or by the States, is to be construed in the light of and limited by the fact that the States and the Union are inseparable, and that the Constitution contemplates the perpetual maintenance of each with all constitutional powers, unembarrassed and unimpaired by any action of the other. The taxing power of the Federal Government does not therefore extend to the means or agencies through or by the employment of which the States perform their essential functions, etc.'

Senator Root continued: "This rule of construction has been maintained for generations. It is undisputed; it was referred to with approval by the Justices who wrote and delivered the opinions in the Pollock case both for any against the judgment. It has been declared again and again by the Supreme Court to be not open to question. It is a rule of construction just as controlling in defining the scope of the proposed amendment as it is in defining our government the apparently unlimited taxing power conferred by the terms of the Constitution has been held not to apply to the instrumentalities of the State. Under it acts of Congress which by their express terms, appeared to include instrumentalities of state government have uniformly been held not to include them.

"This uniform, long-established, and indisputable rule applied to the construction of our Constitution - a rule which has been declared to be essential to a continuance of our dual system of government - forbids that the words of that instrument conferring the power of taxation shall be deemed to apply to anything but the proper subjects of national taxation. Under it we are forbidden to apply the words "from whatever source derived" in the proposed amendment to apply to the instrumentalities of State government."

Third, it is the view of the State of Nevada that there is a significant possibility that the Mortgage Subsidy Bond Tax Act of 1980 is unconstitutional, because:

1. The power of the federal government to regulate the states is at best a limited power, and there is serious question that the "Act" in part, or in whole, exceeds the powers of the federal government.

2. The doctrine of reciprocal immunity from taxation has been established since *The Collector v. Day* (1871). Reciprocal immunity was extended to interest income earned on state securities in *Pollock v. Farmers' Loan and Trust Company*, 157 U.S. 429 (1895). The "Act" unilaterally breaches this reciprocal immunity from taxation without Congress changing the Constitution to authorize it to tax state and municipal securities.

3. The "Act" directly interferes with one of this state's traditional governmental functions and thereby impairs this state's integrity and ability to function effectively in the federal system. The "Act" (a) impairs the state's function with a sunset provision which eliminates all single family mortgage bond programs after 1983 and (b) currently impairs the state's function with permanent rules which have made new single family bond issues impossible to issue to date.

4. *The Amersbach v. City of Cleveland*, 598 F.2d 1033 at 1037 (6th Cir. 1979) case has not been reviewed by the Supreme Court. However, the enclosed opinion by the Nevada Attorney General indicates that both the single and multifamily Housing Division programs can meet the four-pronged test formulated in that case, and therefore, the single and multifamily programs constitutionally would not be taxable by the federal government.

5. The Sixteenth Amendment did not extend any constitutional powers to Congress to tax state and municipal securities. During the ratification process, Congress acknowledged this (see pages 737 to 741 from *Tax Revision Compendium*, H0603, 1958) and the Supreme Court confirmed it in *Evans v. Gore*, (1920).

Fourth, the Mortgage Subsidy Bond Tax Act of 1980 is inconsistent with President Reagan's policies on federalism and the return of powers and responsibilities to the states.

Fifth, any efforts by Congress and the Executive Branch to control, regulate or tax municipal finance is an unconstitutional unilateral taking of State powers and tax revenues to which the federal Treasury is not entitled. This remains true regardless of the volume of municipal finance.

Sixth, instead of trying to use regulation and taxation or municipal finance as a tool to balance the federal budget, as had the Carter Administration attempted, the more proper approach would be to recognize and respect that:

1. Any recent expansion of usage or volume in municipal finance activities has been caused by state and local governments responding to high interest rates caused by high inflation. And the high inflation has been caused by excessive federal budget deficits, excessive federal governmental spending, as a percentage of gross National Product and excessive increases in the monetary supply.

2. The best solution for the federal government is to spend the majority of its efforts to solve high inflation which in turn will solve high interest rates. Then the political need to use municipal finance will diminish - and so will the preceived loss of tax revenues for the U.S. Treasury.

Seventh, the Treasury Department seeks the end of all municipal finance free from federal regulations and taxation. Treasury is justifying its attitude on the basis that the 1968 Federal Industrial Development Bond statute never has been challenged nor overturned and therefore this is sufficient precedent to justify federal regulation and taxation of other municipal finance activities. IDBs are not sufficient nor strong precedent for federal regulation of municipal finance. The only reason there has been no direct constitutional challenge of the 1968 IDB law - nor the 1959 arbitrage regulations - is because the abilities of the states to function within the federal system have not been impaired.

Eight, the states and municipal governments in order to preserve our system of federalism must never give up their rights to finance their functions free from federal regulation and taxation.

Ninth, the states and municipal governments in order to preserve our system of federalism must not accept taxable municipal finance with federal interest rate subsidies as any alternative to their present constitutional rights to issue municipal finance free from federal taxation and regulation.

Tenth, Congress and the Executive Branch should support the return of balance to our fine federal system. The imbalance in our system should be corrected by congressional actions so that other solutions provided by the Constitution need not be resorted to by the States. The federal taxation of municipal finance is but one symptom of our federal system out of balance.

We have attached for further reference two documents. The first is an opinion from the office of the Attorney General of the State of Nevada which analyzes the constitutional history of federal taxation efforts of interest earned on state housing bonds and jurisdiction with the U.S. Supreme Court for legal recourse. The second document contains key pages 737 to 741 from the Tax Revision Compendium, H0603, 1958 wherein the Congress, in 1910, said it clearly did not have any constitutional power nor intent to tax state and municipal securities.

In summary, for the several reasons cited the State of Nevada proposes that full repeal of the Mortgage Subsidy Bond Tax Act of 1980 is the more appropriate action. However, as a partial, temporary solution we do support immediate passage of S.1348 with the understanding that we will continue all efforts to fully repeal the statute.

Sincerely,

A. L. McNitt, Jr.
Administrator

ALM:pt

encs.

cc: Governor Robert List
Senator Paul Laxalt
Senator Howard W. Cannon
Representative James Santini
James L. Wadhams

STATE OF NEVADA
CAPITOL COMPLEX
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FEDERAL TAXATION OF INTEREST EARNED ON STATE HOUSING BONDS

The United States Constitution grants the federal government the "Power To lay and collect Taxes . . . (and) To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers" in Article I Section 8. This seemingly unlimited power is restricted in part by the Tenth Amendment to the Constitution which states "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people".

In interpreting these constitutional provisions, the Supreme Court has developed the doctrine of intergovernmental tax immunity. In McCullough v. Maryland (1819) the Supreme Court held that the supremacy of the Constitution and the laws enacted thereunder immunized the instrumentalities of the federal government from state taxation. In The Collector v. Day (1871) this immunity was interpreted as being reciprocal based upon the separate sovereignties of the States. In each off these cases, the immunity from taxation was found to be woven into the very fabric of the Constitution rather than expressly stated therein.

The immunity from taxation of governmental obligations followed a similar course. In Weston v. City Council (1829) the Supreme Court struck down a city personal property tax on federal obligations, reasoning that it was a tax on "an operation essential to the important objectives for which the government was created . . . it is a burden on the operations of government". Weston v. City Council, 2 Peters (27 U.S.) 449 at 467-469 (1829). This immunity was reciprocally applied to state securities in the case of Mercantile Bank v. New York (1887). Pollock v. Farmers' Loan and Trust Company, 157 U.S. 429 (1895) made it clear that this reciprocal immunity extended to the interest income earned on state securities. In the Pollock case the Court examined the income tax law which Congress enacted in 1894. That law subjected the income derived from state, county and municipal securities to federal income taxation. The Supreme Court held at page 451 that "the authorities fully sustain the proposition that Congress cannot tax the borrowing powers of the States or their municipalities; for clearly if the right to tax existed, it would place the borrowing power of the States completely at the mercy of a majority in Congress, (citations omitted)". Although the Court's decision in Pollock was less than unanimous in the determination that the income tax was a direct tax subject to apportionment, it was unanimous on the point that state and municipal bonds were exempt from federal taxation.

In apparent response to the Pollock decision Congress, in 1909, introduced an amendment to the Constitution to eliminate the requirement of apportionment. The amendment was ratified and became the 16th Amendment. It states that "the Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration". The sweeping language of the 16th Amendment could be read so that it would eliminate not only the apportionment requirement of the Pollock decision but also the portion of Pollock and prior cases relied on therein which stated that state and municipal borrowing was immune from federal taxation. The fear that some might so read the 16th Amendment led to the recommendation in 1910 by Governor Charles Evans Hughes of New York to that State's Legislature that it not be ratified. Other governors and state legislators expressed similar fears that the proposed amendment might be interpreted as extending not only the means of exercising the federal tax power but also the scope of the federal tax power. Rather than chance rejection of the amendment Congress made a record of its promise that it had no such thing in mind. c.f. 45 Cong. Rec. 61st Cong., 2d Sess. Part 3, Pages 2539-2540; Part 2 Pages 1694-1698; and Part 3 Pages 2245-2247. That the purpose of the 16th Amendment was to overrule the apportionment ruling but not the immunity ruling in Pollock was made clear by the Supreme Court in the case of Evans v. Gore (1920). The Congressional promise of 1910 thus became the law in unequivocal terms in 1920; the securities of states and their municipalities remained as immune from federal taxation after the adoption of the 16th Amendment as they had been after adoption of the original Constitution.

As Chief Justice of the Supreme Court, Charles Evans Hughes had the opportunity to reaffirm the Pollock holding in a case questioning the constitutionality of a tax on the gains derived from trading in municipals, Willcuts v. Bunn (1931). The opinion states at Pages 224 and 225 of 282 U.S.:

> The well-established principle is involved that a tax upon the instrumentalities of the States is forbidden by the Federal Constitution, the exemption resting upon necessary implication in order to effectively maintain our dual system of government . . . . And a tax upon the obligations of a State or of its political subdivisions falls within the constitutional prohibition as a tax upon the exercise of the borrowing power of the State.

In compliance with the promise made to secure ratification of the 16th Amendment, Congress explicitly exempted interest earned on state and municipal securities from income taxation in the revenue act of 1913. Act of Oct. 3, 1913, Ch. 166, 38 Stat. 168. Believing that an amendment specifically ending the exemption was necessary, in 1923 the House Ways and Means Committee recommended such an amendment, but the House in 1924 rejected the resolution. 65 Cong. Rec. 43, 347 (1924). In 1933 a joint resolution proposing a similar constitutional amendment to end the exemption was introduced in the Senate, 76 Cong. Rec. 3588 (1933), but this was likewise rejected. Congress was similarly unsuccessful in ending the exemption by statute in 1922, 1923, 1924, 1938, 1942, 1949, 1951, 1954 and 1959. c.f. Maxwell, Exclusion from Income of Interest on State and Local Government Obligations and Ely, Federal Taxation of the Interest Paid by States and Political Subdivisions Upon Their Obligations, in House Comm. on Ways and Means, 86th Cong., 2d Sess., 1 Tax Revision Compendium 701, 702-703 and 783, 789 (1959).

The United States Supreme Court has not had an opportunity since Pollock to rule on the constitutionality of a federal income tax on interest earned from state and municipal securities. In the more general area of intergovernmental tax immunity, however, the Court has had occasion to rule and has reemphasized and reinforced the limitation on such immunity announced in McCullough and Collector v. Day. That limitation is, combining the various phrases used in the cases, that only essential, traditional governmental functions enjoy an immunity from taxation. c.f. Helving v. Gerhardt (1938); Allen v. Regents of the University System of Georgia (1938); Graves v. New York ex. rel. O'Keefe (1939); and New York v. United States (1946). In the more recent case of Massachusetts v. United States (1978) the Court distinguished a nondiscriminatory user fee which "operates only to insure that each member of a class of special beneficiaries of a federal program pay a reasonable approximation of its fairshare of the cost of the program to the national government" from a tax that might trigger intergovernmental tax immunity while being careful to explicitly state that it was neither questioning nor limiting the "present vitality of the doctrine of state tax immunity or the conditions under which it might be invoked". Massachusetts v. United States, 435 U.S. 444 at 454 (1978). After a lengthy review of the genesis of the intergovernmental tax immunity doctrine and the development of the doctrine's present parameters, the Court, at page 459, succinctly concluded that "the purpose of the implied constitutional restriction on the national taxing power is . . . to protect the States from undue interference with their traditional governmental functions". In another recent case the Court had occasion to comment on the vitality of the intergovernmental tax immunity doctrine as applied to federal taxes rather than user fees, albeit in a non-tax case, in its widely quoted opinion in National League of Cities v. Usery, 426 U.S. 833 (1976). The Court stated:

> This Court has never doubted that there are limits upon the power of Congress to override state sovereignty, even when exercising its otherwise plenary powers to tax or to regulate commerce which are conferred by Art. I of the Constitution. (at 842).
>
> The (Tenth) Amendment expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system . . . (at 843).

The Court then characterized its decision in New York v. United States as having rejected "the proposition that Congress could impose taxes on the States so long as it did so in a non-discriminatory manner" at page 843. After quoting, at page 844, an aphorism from an earlier decision that "the Constitution in all its provisions, looks to an indestructible Union, composed of indestructible States" the Court continued at page 847, that the vice of the federal statute there being examined was that "quite apart from the substantial costs imposed on the States and their political subdivisions, the Act displaces state policies regarding the manner in which they will structure delivery of these governmental services which their citizens require". The Court repeated at pages 851 and 852 that the vice of the federal statute being examined was that it would "impermissibly interfere with the integral governmental functions of (the states)", concluding that under our Constitution the federal government may not "wield its power in a fashion that would impair the States' ability to function effectively in a federal system".

Stating that the federal government may not infringe, through the levy of a national income tax, the 'essential, traditional functions of State and local government' obviously begs the question of how one determines whether or not a particular state activity is within the protected class. The Supreme Court's opinion in National League of Cities provides examples of immune activities when it states at page 851:

> Such areas as fire prevention, police protection, sanitation, public health and parks and recreation . . . are typical of those performed by State and local governments in discharging their dual functions of administering the public law and furnishing public services. Indeed, it is functions such as these which governments are created to provide, services such as these which the States have traditionally afforded their citizens.

In a footnote to this section of the opinion the Court states "these examples are obviously not an exhaustive catalog of the numerous line and support activities which are well within the area of traditional operations of State and local governments." The opinion continues at page 885 that "schools and hospitals . . . and . . . fire and police departments . . . each provide an integral portion of those governmental services which the States and their political subdivisions have traditionally afforded their citizens".

One attempt to formulate a test for immune activities that may prove helpful is contained in Amersbach v. City of Cleveland, 598 F.2d 1033 at 1037 (6th Cir., 1979):

> [T]he terms 'traditional' or 'integral' are to be given a meaning permitting expansion to meet changing times . . . By analyzing the services and activities which the Court (in National League of Cities) characterized as typical of those performed by governments, we note certain elements common to each which serve to clarify and define a method by which a protected government function may be identified. Among these elements are: (1) the government service or activity benefits the community as a whole and is available to the public at little or no direct expense; (2) the service or activity is undertaken for the purpose of public service rather than for pecuniary gain; (3) government is the principal provider of the service or activity; and (4) government is particularly suited to provide the service or perform the activity because of a communitywide need for the service or activity.

Obviously, this four-pronged test cannot be applied mechanically, for if it were, one or more of the activities described as being illustrative of traditional, essential government functions in National League of Cities would be ruled out. It would be a unique public hospital, for example, that provided services "available to the public at little or no direct expense". Likewise the second and third prongs could easily eliminate the listed activities if given an excessively literal reading. As one commentator has observed:

> Americans customarily look not only to State and local governments but also to the private sector for services in various fields that typify local government activity. There are private elementary and secondary schools, private refuse scavengers and water companies, private plant watchmen and detectives, private health insurers and hospitals . . . Our needs in such fields are to be served, we customarily think, by some mixture of governmental and private activity. Michelman, States' Rights and States' Roles: Permutations of 'Sovereignty' in National League of Cities v. Usery, 86 Yale Law Journal 1165 at 1175 (1977).

With these caveats in mind, the four factors enumerated in Amersbach provide an appropriate framework to evaluate whether housing for low and moderate income persons provided or assisted by State government is an essential, traditional government activity.

All State functions must serve a public purpose to pass muster under most State constitutions. It is thus not necesarily true that every activity with a valid public purpose would be protected under National League of Cities. It would seem, however, that any activity passing the public purpose test should have little difficulty passing at least the first two prongs of the Amersbach test. State programs financed through revenue bonds that assist low and moderate income persons to obtain housing they would otherwise be unable to afford have been found to serve a valid public purpose by many State Supreme Courts. c.f. John R. Grubb, Inc. v. Iowa Housing Finance Authority (1977) and the citation therein to opinions of the Supreme Courts of Alaska in 1966, Illinois in 1948, Maine in 1971, Massachusetts in 1969, Minnesota in 1973, New Jersey in 1970, Rhode Island in 1973, Vermont in 1970, West Virginia in 1969, and Wisconsin in 1973.

To the extent such a State housing program is limited to those persons not served by and those types of housing not provided by the private sector, there should be little difficulty in meeting the third and fourth requirements of the Amersbach test. c.f. The decision of the United States Court of Appeals for the second circuit on September 15, 1980 in the case of United Transportation Union v. Long Island Railroad.

To summarize the foregoing, a continuous theme runs through and unites the opinions of the United States Supreme Court from McCullough v. Maryland through Massachusetts v. U. S. Notwithstanding the seemingly unlimited power to tax contained in Art. I Sec. 8 and the 16th Amendment, our federal system prohibits the national government from applying an income tax to the interest earned on state or municipal obligations. While the decisions of the past half century have drifted in the direction of limiting the scope of the reciprocal tax immunity doctrine generally, on the specific point of tax exemption of state and municipal obligations, the Court has never deviated from its Pollock holding.

JURISDICTION

If a State were to challenge the constitutionality of the so-called "Mortgage Subsidy Bond Tax Act of 1980" as an impermissible interference with State housing programs financed through State bonds; such an action might be entertained by the United States Supreme Court in its original jurisdiction. This would eliminate the time and expense involved in prosecuting a case on the State or lower federal court level and then prosecuting or defending appeals on up through the United States Supreme Court. Such original jurisdiction is provided for in Article 3 Section 2 of the Constitution. But by federal statute, jurisdiction is not exclusive in the Supreme Court, 28 USC Section 1251 (b) (2), and so such an action might be returned to the U. S. District Courts which have coextensive jurisdiction with the Supreme Court in such cases.

A stumbling block to such an action, which may prevent a State from ever directly litigating the deprivation of its constitutional rights, lurks in the federal statutes prohibiting a federal court from entertaining such an action contained in the Declaratory Judgment Act and in the Internal Revenue Code. The former states in 28 USC Section 2201 "in a case of actual controversy within its jurisdiction, except with respect to Federal taxes . . . any court of the United States . . . may declare the rights and other legal relations of any interested party seeking declaration . . .". The so-called Anti-injunction Act in the Internal Revenue Code provides, at 26 USC Section 7421 "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed".

The Supreme Court in Bob Jones University v. Simon (1974) held that unless the petitioner could demonstrate that both equity jurisdiction existed (the petitioner would suffer irreparable injury in the absence of an injunction) and that the federal government could not under any circumstances prevail on the merits, a federal court would not make an exception to the anti-injunction act. In so holding, the Court relied on the earlier case of Enochs v. Williams Packing and Navigation Company (1962) which first formulated this two-pronged test. The Court characterized Williams Packing as having been "undertaken to rehabilitate" the anti-injunction act from "debilitating departures" in a pair of Supreme Court cases decided in the 1930's. Those cases were described as having reduced the anti-injunction act to a mere requirement that traditional equity requirements existed for the issuance of an injunction. The Court paints this chronology with too broad a brush, however, when it ignores the unique status of the respondent in one of those 1930's cases. Specifically in Allen v. Regents of the University System of Georgia (1938) the respondent was an instrumentality of the State of Georgia. While a literal reading of Regents as requiring no more than traditional equity jurisdiction would not be incorrect, it ignores the fact that the respondent there was a State and not a taxpayer. Because it was not a taxpayer, if the anti-injunction act had been invoked according to its literal terms it would have had the effect of denying the State of Georgia any access to the courts.

Although the Bob Jones case seems to say that modification of the Williams Packing two-pronged test will not be permitted, two years after Bob Jones, in separate cases involving alleged drug dealers who had been subjected to jeopardy assessments, the Court held the anti-injunction act inapplicable. In Laing v. U. S. (1976) the act was not applied because the Internal Revenue Service had employed a procedure which would have denied the taxpayer any access to the Tax Court if the act had been mechanically applied. In the case of Commissioner of Internal Revenue v. Shapiro (1976) the Court likewise refused to mechanically apply the Williams Packing test and required instead that once the taxpayer put the government's inability to prevail on the merits in issue, it became incumbent upon the court to resolve this prong of the Williams Packing test before employing the act to bar the injunction.

It would thus be inappropriate to conclude that proving the merits of the State's claim will be the only substantial obstacle in challenging this unconstitutional act of the federal government. One should anticipate that the federal government will employ every procedural or jurisdictional subterfuge or device available to foreclose the State from obtaining its day in court. Recent Supreme Court decisions seem to indicate, on balance, that some judicial forum must remain open to every litigant with a case or controversy relating to the federal tax laws.

TESTIMONY

BY

M. GREGG SMITH
ADMINISTRATOR, OREGON HOUSING DIVISION

BEFORE

U.S. SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
WASHINGTON, D.C.
OCTOBER 16, 1981

TESTIMONY OUTLINE

INTRODUCTION.

BACKGROUND OF STATE ROLE IN HOUSING FINANCE.

OREGON'S PROGRAM HAS SERVED YOUNG, MODERATE-INCOME, FIRST-TIME HOME BUYERS PURCHASING SMALLER, OLDER, "STARTER" HOMES.

OREGON'S LONG-STANDING SUPPORT OF FEDERAL RESTRAINTS ON MORTGAGE REVENUE BONDS.

MORTGAGE BOND ACT MOVED BEYOND RESTRAINT TO ABOLITION.

STATES CAN LIVE WITH PROGRAM LIMITS ON MORTGAGE BOND ACT. HOWEVER, TECHNICAL PROVISIONS OF ACT ARE UNWORKABLE. THEY ARE: 95% TEST, ARBITRAGE, REGISTRATION.

OREGON'S EXPERIENCE WITH REGISTERED BONDS.

THE NEGATIVE CONSEQUENCES OF BOND REGISTRATION.

SUMMARY.

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, MY NAME IS GREGG SMITH. I AM ADMINISTRATOR OF THE HOUSING DIVISION OF THE STATE OF OREGON. IT IS A GREAT HONOR FOR ME TO HAVE THE OPPORTUNITY TO SPEAK TO YOU AND TESTIFY IN FAVOR OF S. 1348. I WOULD LIKE TO TAKE A MOMENT TO PROVIDE AN HISTORICAL OVERVIEW OF THE ISSUE BEING ADDRESSED TODAY.

STATE HOUSING FINANCE AGENCIES HAVE BEEN OPERATING HIGHLY-REGARDED PROGRAMS FOR APPROXIMATELY 20 YEARS. THE VAST MAJORITY OF OUR PROGRAMS HAVE SERVED LOW AND MODERATE INCOME RENTERS AND HOME BUYERS. WE HAVE FILLED A GAP BETWEEN CONVENTIONAL LENDERS WHO SERVE, PRIMARILY, ABOVE-MEDIAN-INCOME HOME BUYERS AND FEDERALLY SUBSIDIZED HOUSING PROGRAMS WHICH SERVE, PRIMARILY, VERY LOW INCOME RENTERS.

IN THE 1970'S AN INCREASING NUMBER OF STATE HOUSING FINANCE AGENCIES INSTITUTED PROGRAMS TO ASSIST BELOW-MEDIAN-INCOME FAMILIES TO PURCHASE HOMES. THE REASONS FOR THIS TREND WERE MANIFOLD. FIRST, IN THE 1970'S MANY NEW STATE HOUSING FINANCE AGENCIES WERE CREATED IN THE SOUTH, MIDWEST AND WEST WHERE THE PREDOMINANT SHELTER-TYPE WAS SINGLE FAMILY HOMES. SECOND, DURING THIS PERIOD CONVENTIONAL MORTGAGE INTEREST RATES ROSE DRAMATICALLY, PRICING INCREASING NUMBERS OF FAMILIES OUT OF HOUSING OPPORTUNITIES. THIRD, THE POST-WORLD WAR II "BABY BOOM" GENERATION BEGAN TO HIT THE MARKET ABOUT THIS TIME CREATING TREMENDOUS DEMAND FOR OWNED UNITS.

ATTACHMENT "A" IS A STATUS REPORT ON OUR MORTGAGE PURCHASE PROGRAM FOR 1980. DURING THAT YEAR, WE FINANCED 1795 SINGLE FAMILY HOMES. TO SUMMARIZE THE DATA, THE PROGRAM SERVED PRIMARILY YOUNG, MODERATE-INCOME, FIRST-TIME HOME BUYERS WHO WERE BUYING SMALLER, OLDER, "STARTER" HOMES IN THE URBAN AREAS.

IN MID-1978 CERTAIN CITIES AND COUNTIES STARTED TO ISSUE MORTGAGE REVENUE BONDS TO FINANCE HOMES FOR MIDDLE AND UPPER INCOME FAMILIES. WE OBJECTED TO THESE PROGRAMS BECAUSE THEY LACKED A CLEAR PUBLIC PURPOSE AND WE WERE CONCERNED THAT THE BOND MARKET WOULD BE SWAMPED BY EXCESSIVE BOND VOLUME. (WE CAN ALSO APPRECIATE THE THEORY OF REVENUE LOSS BUT FEEL IT IS NOT ENTIRELY SOUND GIVEN THE MANIFOLD TAX SHELTER OPTIONS AVAILABLE TO INVESTORS.)

ATTACHMENT "B" OF MY TESTIMONY IS A COPY OF AN APRIL 6, 1979 LETTER I SENT TO FORMER REPRESENTATIVE AL ULLMAN URGING CONGRESSIONAL RESTRAINTS ON THE ISSUANCE OF MORTGAGE REVENUE BONDS, PARTICULARLY THOSE ISSUED BY CITIES AND COUNTIES TO FINANCE MIDDLE AND UPPER INCOME HOUSING. THIS LETTER PREDATED THE INTRODUCTION OF H.R. 3712 WHICH ULTIMATELY RESULTED IN MORTGAGE BOND LEGISLATION. ATTACHMENT "C" IS A MAY 11, 1979 LETTER OREGON GOVERNOR VICTOR ATIYEH SENT TO FORMER REPRESENTATIVE ULLMAN URGING LIMITATIONS ON THE ISSUANCE OF MORTGAGE REVENUE BONDS BUT ALLOWING FOR THE CONTINUATION OF LONG-STANDING, WORTHY

STATE EFFORTS. THESE LETTERS MAKE IT CLEAR THAT WE HAVE LONG SUPPORTED REASONABLE RESTRAINTS ON THE ISSUANCE OF MORTGAGE REVENUE BONDS.

OUR INITIAL SUPPORT OF CONGRESSIONAL EFFORTS TO RESTRAIN MORTGAGE REVENUE BOND PROGRAMS BORE BITTER FRUIT. WHAT HAPPENED WAS NOT RESTRAINT - IT WAS ABOLITION OF THE GOOD PROGRAMS ALONG WITH THE BAD. PERHAPS THIS WAS THROUGH OVERSIGHT. WHEN I TALKED WITH REPRESENTATIVE ULLMAN ABOUT THIS MATTER IN 1979, HE TOLD ME THAT IT WAS HIS INTENT TO ALLOW FOR THE CONTINUATION OF A REASONABLE AMOUNT OF MORTGAGE BOND ACTIVITY. HE TOLD ME HE KNEW THAT THE HOUSE BILL WAS FLAWED, BUT THAT IT WAS THE BEST BILL HE COULD GET OUT OF THE WAYS AND MEANS COMMITTEE AT THAT TIME. HE INDICATED WE WOULD HAVE AN OPPORTUNITY TO CORRECT THE DEFECTS IN THE BILL ONCE IT GOT TO THE SENATE. AS YOU KNOW, THIS NEVER HAPPENED. INSTEAD, THE HOUSE BILL BECAME LAW THROUGH CONFERENCE COMMITTEE ACTION ON THE OMNIBUS RECONCILIATION ACT OF 1980. WE FEEL THE UNWORKABILITY OF THE MORTGAGE BOND LEGISLATION IS CONTRARY TO THE STATED INTENT OF CONGRESS AND CONTRARY TO THE STATED INTENT OF THIS ADMINISTRATION. I WOULD CONCEDE, HOWEVER, THAT IT MAY NOT BE CONTRARY TO THE HOPES OF CERTAIN ELEMENTS OF THE FEDERAL BUREAUCRACY.

WE CAN LIVE WITH THE PROGRAMMATIC RESTRAINTS IN THE MORTGAGE BOND LEGISLATION. THEY ARE COMPLICATED, UNWIELDY AND OF QUESTIONABLE VALUE, BUT WE CAN LIVE WITH THEM. WE CANNOT LIVE WITH VARIOUS TECHNICAL PROVISIONS OF THE ACT. THOSE TECHNICAL PROVISIONS ARE THE SO-CALLED 95% GOOD-FAITH QUESTION, THE ARBITRAGE LIMITS AND THE REGISTRATION REQUIREMENT. ATTACHMENT "D" IS A FEBRUARY 13, 1981 MEMO I SENT TO TERRY KAY ON YOUR STAFF, MR. CHAIRMAN. THE MEMO DETAILS MY CONCERNS IN THESE AREAS. RESOLUTION OF THE GOOD-FAITH AND ARBITRAGE PROBLEMS ARE CRITICAL TO THE CONTINUATION OF OUR PROGRAMS. HOWEVER, OTHER PEOPLE HERE TODAY WILL SPEAK TO THOSE POINTS. I WOULD LIKE TO FOCUS MY ATTENTION ON AN AREA WHERE I HAVE SPECIFIC DATA, NAMELY, THE QUESTION OF REGISTRATION.

ON JUNE 23, 1981, THE STATE OF OREGON HAD A GENERAL OBLIGATION BOND SALE. WITHIN THE SALE WERE TWO SEPARATE ISSUES. ONE WAS FOR ALTERNATE ENERGY PROJECTS AND THE OTHER WAS FOR WATER RESOURCE FACILITIES. THE ENERGY BONDS WERE REQUIRED TO BE REGISTERED BY FEDERAL LAW. WHEN SOLD, THE DIFFERENCE IN NET INTEREST COST BETWEEN THE ENERGY AND WATER RESOURCES BONDS WAS 70 BASIS POINTS. CORRECTING FOR DIFFERENCES IN STRUCTURING OF THE TWO ISSUES, THE DIFFERENTIAL IS PROBABLY CLOSER TO 50 BASIS POINTS. EVEN SO, THE COST REMAINS STAGGERING. EARLY THIS YEAR, THE DAILY BOND BUYER PUBLISHED A COMPILATION OF ALL

TAX-EXEMPT MORTGAGE BONDS SOLD IN 1980. THE AMOUNT TOTALED $14,229,710,144. IF WE ASSUME A 10% RATE FOR COUPON BONDS VERSUS A 10.5% RATE FOR REGISTERED BONDS AND ASSUMING A 30-YEAR TERM, THE NIC DIFFERENTIAL COSTS ARE AS FOLLOWS:

MORTGAGE BONDS	REGISTERED	NIC	INTEREST	ADDITIONAL INTEREST DUE TO REGISTRATION
$14,229,710,144	YES	10.5%	$32,775,704,036	$1,901,630,004*
$14,229,710,144	NO	10.0%	$30,874,074,032	—

THE PROBLEM THAT REGISTRATION SEEKS TO ADDRESS IS ONLY ASSERTED. APPARENTLY CERTAIN ELEMENTS OF THE FEDERAL BUREAUCRACY FEEL, BUT CANNOT PROVE, THAT SOME PEOPLE AVOID FEDERAL ESTATE TAXES WHEN A BONDHOLDER DIES LEAVING REDEEMABLE BOND COUPONS IN THE FAMILY SAFE DEPOSIT BOX. PERHAPS THIS HAPPENS. EVEN IF IT DOES, WHAT HAS BEEN PROPOSED AS A SOLUTION IS LIKE KILLING MOSQUITOES WITH MX MISSILES.

* ASSUMPTIONS:

- The interest cost comparison is on a net interest cost basis which is a valid basis because it deals in actual dollars paid out ignoring the time-value of money. The computation is taken from the "Semiannual Compound Interest and Annuity" tables, Thorndike Encyclopedia of Banking and Financial Tables, revised edition, 1980
- All bonds are 30-year term bonds. This increases the NIC, but provides a common basis of comparison.

REGISTRATION DRAMATICALLY INCREASES BORROWING COSTS; IT INHIBITS SECONDARY MARKET TRANSACTIONS; IT PUTS MORE TAX-EXEMPT INTEREST IN THE MARKET, AND IT CREATES ADDED PAPER WORK. PERHAPS IT IS BECAUSE OF THESE NEGATIVE FEATURES THAT FEDERAL GOVERNMENT BONDS ARE NOT REGISTERED.

I'D LIKE TO SUMMARIZE BY SAYING THE FOLLOWING: WE BELIEVE IT IS A VALID PUBLIC PURPOSE FOR STATES TO PROVIDE OPPORTUNITIES FOR YOUNG, BELOW-MEDIAN-INCOME FAMILIES TO PURCHASE HOMES. WE HAVE CREATED OUR PROGRAMS WITH SMALL STAFFS, AT LOW COST, TO ACCOMPLISH THIS OBJECTIVE. WE HAVE WORKED COOPERATIVELY WITH THE PRIVATE SECTOR TO SERVE A CLIENT GROUP THE PRIVATE SECTOR CANNOT REACH. CAPITAL FOR HOUSING IS SCARCE AND IS MOVING INTO AREAS WHERE INVESTMENT POTENTIAL IS GREATER. FEDERAL RESOURCES FOR HOUSING ARE DECLINING. ON A LIMITED LEVEL, WE BELIEVE A RESPONSE TO THESE CIRCUMSTANCES IS WARRANTED. STATES, SUCH AS OURS, HAVE A PROVEN, PRUDENT MODEL WHICH SHOULD BE ALLOWED TO CONTINUE TO OPERATE.

THANK YOU MR. CHAIRMAN.

ATTACHMENT "A"

MORTGAGE PURCHASE PROGRAM

Housing Characteristics: Loans Purchased During 1980

Targeted Census Tracts, City of Portland and Rest of State

1. Borrower Information	Target Areas, Portland	Rest of State
A. Median Household Income	$18,953	$17,622
Under $10,000	0.5%	0.7%
10,000 - 11,999	1.1%	2.6%
12,000 - 13,999	4.1%	7.2%
14,000 - 15,999	9.9%	15.1%
16,000 - 17,999	17.6%	30.2%
18,000 - 19,999	35.6%	44.2%
20,000 and above	27.3%	0%
B. Median Age	27.4	27.8
Under 20	1.3%	1.5%
20 - 24	25.9%	26.9%
25 - 29	46.2%	38.5%
30 - 39	21.8%	23.5%
40 - 49	3.1%	3.9%
50 - 59	1.4%	2.8%
60 +	0.4%	2.8%
C. Median Household Size	1.8	2.0
D. Number of Minors in Household		
0	75.2%	69.0%
1	14.4%	15.8%
2	7.4%	11.2%
3	2.0%	3.0%
4 +	1.0%	1.0%
E. Previous Tenancy		
Owners	9.4%	18.0%
Renters	90.6%	82.0%
2. Property Information		
A. Median Purchase Price	$43,955	$43,465
Under - $25,000	0.5%	1.4%
25,000 - 29,999	2.5%	3.5%
30,000 - 34,999	7.0%	7.7%
35,000 - 39,999	18.5%	18.6%
40,000 - 44,999	27.1%	27.3%
45,000 +	44.3%	41.6%
B. Median Loan Amount	$39,355	$37,735
Under - $20,000	0.7%	1.2%
20,000 - 24,999	1.4%	3.4%
25,000 - 29,999	5.7%	8.5%
30,000 - 34,999	17.2%	19.3%
35,000 - 39,999	28.5%	32.3%
40,000 - 44,999	30.3%	29.8%
45,000 +	16.0%	5.6%
C. Median Downpayment-Percent	9.1%	10.5%
Less than 5%	8.3%	10.2%
5% - less than 10%	50.9%	36.5%
10% - less than 20%	28.1%	33.1%
20% or more	12.7%	20.2%
D. Year Built: Median	1934	1965
Before 1920	19.9%	2.7%
1920 - 1939	42.2%	13.5%
1940 - 1959	25.2%	29.4%
1960 - 1969	2.7%	8.2%
1970 - 1976	1.6%	8.8%
1977 - to present	8.3%	37.4%
E. Unit Type		
Single Family	99.1%	73.4%
Mobile Homes	.7%	4.9%
Condominiums	.0%	18.9%
Other	.2%	2.8%

NOTE: Unit type does not include FHA-insured loans (which are about one-third of these loans) because FHA does not usually collect this information.

MORTGAGE PURCHASE PROGRAM

Number of Loans in 1980 by City and County

County	1980 Population[1]	# of Loans	% of State Population	% of State Loans
Baker	16,127	7	0.6%	0.4%
Benton	68,078	31	2.6%	1.7%
Clackamas	239,062	63	9.1%	3.5%
Clatsop	32,467	3	1.2%	0.2%
Columbia	35,704	1	1.4%	0.1%
Coos	63,930	8	2.4%	0.4%
Crook	13,097	12	0.6%	0.7%
Curry	16,935	0	0.6%	0.0%
Deschutes	61,968	95	2.4%	5.3%
Douglas	93,100	36	3.6%	2.0%
Gilliam	2,061	0	0.1%	0.0%
Grant	8,216	0	0.3%	0.0%
Harney	8,306	2	0.3%	0.1%
Hood River	15,810	4	0.6%	0.2%
Jackson	131,738	50	5.0%	2.8%
Jefferson	11,556	3	0.4%	1.6% *
Josephine	56,016	17	2.1%	0.9%
Klamath	59,002	48	2.3%	2.7%
Lake	7,523	1	0.3%	0.1%
Lane	273,266	153	10.4%	8.5%
Lincoln	35,315	5	1.3%	0.3%
Linn	87,743	41	3.4%	2.3%
Malheur	26,891	5	1.0%	0.3%
Marion	204,454	172	7.8%	9.6%
Morrow	7,525	3	0.3%	0.2%
Multnomah	558,877	836	21.4%	46.6%
Polk	45,201	24	1.7%	1.3%
Sherman	2,177	0	0.1%	0.0%
Tillamook	21,170	2	0.8%	0.1%
Umatilla	58,840	34	2.2%	1.9%
Union	23,935	3	0.9%	0.2%
Wallowa	7,269	0	0.3%	0.0%
Wasco	21,711	4	0.8%	0.2%
Washington	245,633	113	9.4%	6.3%
Wheeler	1,511	0	0.1%	0.0%
Yamhill	55,230	19	0.2%	1.1%
TOTAL	2,617,444	1,795	100.0%	100.0%

City	1980 Population	# of Loans	% of State Population	% of State Loans
Portland	364,891	838	13.9%	46.7%
Eugene	104.672	68	4.0%	3.8%
Salem	89,161	166	3.4%	9.2%
Springfield	41,227	61	1.6%	3.4%
Corvallis	40,843	29	1.6%	1.6%
Medford	39,506	37	1.5%	2.1%
Gresham	32,704	15	1.2%	0.8%
Beaverton	31,948	27	1.2%	1.5%
Albany	26,497	21	1.0%	1.2%
Hillsboro	30,666	17	1.2%	0.9%
Lake Oswego	22,319	19	0.9%	1.1%
Milwaukie	17,834	31	0.7%	1.7%
Bend	17,121	78	0.7%	4.3%
Klamath Falls	16,646	43	0.6%	2.4%
Roseburg	16,535	21	0.6%	1.2%
Balance of State	1,724,874	324	65.9%	18.0%
TOTAL	2,617,444	1,795	100.0%	100.0%

[1] Source: 1980 Census, Preliminary Report.

*Corrected - June, 1981

ATTACHMENT "B"

April 6, 1979

Representative Al Ullman
1136 LHOB
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Ullman:

The State Housing Division issues both revenue and general obligation bonds to finance low and moderate income housing. To date, we have issued $34,315,000 in revenue and general obligation bonds to finance multi-family housing, most of which serves low income elderly persons. We have also issued $166,310,000 in revenue bonds to finance single-family housing, most of which serves young, first-time home buyers. Under this latter program, we offer mortgage financing at 7.25% interest to persons with incomes below $16,500 to purchase a home valued at less than $47,000.

In the last year, municipalities have begun to use tax-exempt revenue bonds to finance single-family homes. In many of these programs there are no income limits, or income limits so high as to beg the question of public purpose. The glut of such bond issues on the tax-exempt bond market is radically escalating the price that we have to pay for our bonds. As a result, those persons who truly need lower-cost financing to obtain a home are being denied this opportunity by the proliferation of programs with questionable merit.

It is my understanding that Congress will soon take up the question of municipal mortgage revenue bonds. I strongly support congressional review of this matter and congressional restraints on municipal mortgage revenue bonds. I also support the enclosed policy statement developed by the Council of State Housing Agencies on municipal mortgage revenue bonds. This policy statement was thrashed out as a result of long research and discussion among the directors of state housing finance agencies throughout the United States. I commend it to your attention.

I am enclosing a copy of the latest status report on our single-family mortgage assistance program. This data leaves no question as to the public purpose of our effort. Our program is an excellent use of the tax-exempt bond privelege. Also enclosed is a recent article from The Weekly Bond Buyer on this issue.

I urge you to move forward to call hearings on municipal mortgage revenue bonds and report out legislation to restrict their use to narrowly defined public purposes.

Sincerely,

M. Gregg Smith
Administrator

MGS/ss

cc: The Honorable Les AuCoin
Member of Congress

The Honorable Michael Blumenthal
Secretary, Treasury Department

Enclosures

ATTACHMENT "C"

OFFICE OF THE GOVERNOR
STATE CAPITOL
SALEM 97310

May 11, 1979

The Honorable Al Ullman
United States Representative
231 Cannon House Office Building
Washington, D.C. 20515

Dear Al:

I applaud your decision to introduce H.R. 3712, which would place limitations on the issuance of tax-exempt mortgage bonds. The proliferation of mortgage bond programs and the abuses in some of those programs threaten to undermine existing programs aimed at low- and moderate-income families.

I appreciate the invitation you have extended to Gregg Smith, Administrator of the State Housing Division, to testify at the hearings on H. R. 3712. Mr. Smith will brief you on state mortgage bond programs and make specific recommendations on H.R. 3712.

While there may be a variety of public purpose programs which should be exempted from H.R. 3712, I am limiting my comments to proposed amendments which would allow for a continuation of worthy state programs. My recommendations are as follows:

1. Exempt All General Obligation Bonds.

There is currently an exemption in H.R. 3712 for general obligation mortgage bonds which serve veterans. I would like to see this exemption extended to cover all general obligation mortgage bonds.

In 1978, Oregon voters approved a program to finance multi-unit housing for elderly persons. This is clearly a worthy and needed program. The Oregon Legislature is also considering a bill to allow the issuance of a modest number of general obligation bonds to finance the rehabilitation of multi-unit structures in blighted urban areas. If approved by the Legislature, this measure will go to the voters at the next statewide election.

The small scope of these programs, their social and economic benefit, and the fact that the voters have expressed their willingness to stand behind the bonds should be valid reasons for exempting them from H.R.3712.

2. Exempt Mortgage Revenue Bonds Serving Borrowers Below the Median-Family-Income Level.

I feel that there should be an exemption in H. R. 3712 for mortgage revenue bond programs which are limited to borrowers below the median-family-income level.

The State of Oregon has a very successful program which enables below-median-income borrowers to purchase modest homes. The program is a cooperative effort between the state and participating private lending institutions, who originate and service the loans. To date, we have issued revenue bonds sufficient to finance 6,000 single-family homes. Most of the borrowers are young, moderate-income, first-time home buyers. This program serves people who could not hope to own their own homes were it not for below-market mortgage financing.

3. Limit Federal Agency Control.

I am concerned that certain federal bureaucracies will see the discussions around H.R. 3712 as an opportunity to gain power for themselves by forcing state governments to channel housing programs through them and target state efforts at their objectives. We have done an outstanding job in Oregon with the programs we have operated. We agree that Congress should set limitations on the issuance of mortgage bonds, but leave implementation of approved activities to people closer to the problem.

In summary, the mortgage bond programs operated by the State of Oregon have the support of private financial institutions, builders, realtors, the mobile home industry, private mortgage insurance companies, and the public at large. We think these programs are good for Oregon in that they attract out-of-state investment capital to provide housing opportunities for those who would not otherwise have them.

We urge you to take a firm position in opposition to those programs which clearly abuse the tax-exempt privilege, but to leave intact programs, such as those in Oregon, which serve a clear public purpose.

Sincerely,

Victor Atiyeh
Governor

VA/slg

ATTACHMENT "D"

STATE OF OREGON

INTEROFFICE MEMO

TO: Terry Kay
Office of Senator Packwood

DATE: February 13, 1981

FROM: M. Gregg Smith, Administrator
Housing Division

SUBJECT: Meeting Concerning Mortgage Subsidy Bond Tax Act of 1980 - Issues

The following is a briefing paper on the issues to be raised at the February 13 meeting with Senator Packwood concerning the Mortgage Subsidy Bond Tax Act of 1980 (The Mortgage Bond Act).

PROGRAM OVERVIEW

For five years, the State of Oregon has operated a very successful "Mortgage Purchase Program" under which tax-exempt state revenue bonds are issued to provide below-market-rate mortgage loans for below-median-income purchasers of single family homes. The program is run by a three-person program staff within the State Housing Division. This staff purchases loans originated to eligible borrowers by conventional lenders. The loans are then serviced by the originating lender.

Attached to this memo is an analysis of the 1,795 loans financed last year under the Mortgage Purchase Program. You will note that the bulk of the loans are made to young, moderate income, first-time homebuyers who are purchasing moderately priced, older homes principally in urban areas. Were it not for this program, the vast majority of program participants would not have had an opportunity to own a home.

STATE POSITION ON MORTGAGE BOND ACT

In 1978 when cities and counties began issuing mortgage bonds to finance middle and upper income single family housing, the State Housing Division supported the concept of restrictive federal legislation to halt what it perceived as an abuse of the tax-exempt privilege. (Please don't ask me to square this with the State Veterans' Loan Program.) Our major concern was that the market would be glutted by mortgage bonds, driving out programs which aimed at low and moderate income clients.

When Representative Ullman introduced restrictive federal legislation, we supported it because we were assured by Representative Ullman and his staff that it was his intention to weed out the bad programs while allowing the programs which served clear public purposes to continue at some reasonable level.

ISSUE 1. WHAT WAS THE INTENT OF CONGRESS?

Was it the intent of Congress, as we were assured, that some reasonable level of single family housing bonding activity would be allowed to continue? If this was the intent of Congress, then it is my firm belief that Congress was misled by the Joint Committee on Taxation and the U. S. Treasury Department. The Mortgage Bond Act as passed is unworkable. If it is workable, why have no new bond sales occurred since its enactment?

Contains Recycled Materials

Request

Reaffirm the previous statement of the intent of Congress to allow the continuation of single family housing bonding programs at some reasonable level.

ISSUE 2. THE "GOOD FAITH" QUESTION

Assuming that Congress does wish to allow some reasonable level of single family housing bonding activity, there are two major non-program issues which make the Mortgage Bond Act unworkable. They are:

a) Section 103A (c)(2)(B)

Under this Section, one is required to make a good faith effort to comply with the mortgage eligibility requirements. We have no problem with (i) which says that issuers will make a good faith effort to meet all the requirements, nor with (iii) which says that if an issuer fails to meet the requirements, the deficiency will be corrected within a reasonable period. However, (ii) says that notwithstanding any good faith effort, nor an issuer's affirmative efforts to correct a deficiency, 95% of the proceeds of a bond sale must be devoted to owner financing of residences with respect to which all requirements are met. This presents us with a serious problem. It is conceivable that errors could be made or fraud could be perpetrated which would exceed 5% of the bond proceeds. If this happened, the bonds would become taxable.

Request

Amend 103A (c)(2)(B) by deleting the 95% test in (ii).

b) Section 103A (c)(2)(C)

Under this Section, there is a different standard than that which applies in (c)(2)(B). Here, reference is made to 103A (j)(2) and (3) concerning the requirements that mortgages must be new mortgages and assumed mortgages may only be assumed by someone who meets the other requirements of the Act. However, one is not provided an opportunity to correct a deficiency unless it is inadvertent error. Thus, it is possible that an issuer could take some action which would be determined by the IRS to be other than "inadvertent error", even though in good faith, and the bonds would automatically become taxable. Again, the issue is black and white. There is no provision allowing the issuer to correct a deficiency.

Request

Amend 103A (c)(2)(C) by deleting (ii) and replacing it with language similar to (c)(2)(B)(iii) which provides a procedure for correcting a deficiency.

ISSUE 3. ARBITRAGE

a. Spread

The Mortgage Bond Act changes existing IRS arbitrage regulations which permit mortgages made from bond proceeds to exceed the effective interest cost on the bonds by 1-1/2%. The new limit is 1%. However, the Act changes the procedure by which one calculates the 1%. It includes in the yield calculation the cost of issuing the bonds, trustee's fees, loan origination and loan servicing fees, etc. These calculations reduce the effective spread to closer to 1/2%. The Housing Division's program traditionally had limited the spread to the lowest possible level so as to provide its clients with the lowest possible mortgage interest rate. The average spread over all our single family bond sales has been a bit above 9/10 of 1% after excluding the costs of issuance, etc., from the yield calculation. These costs add up to about 1/4 of 1%. Thus, we would need 1-1/4% spread under the new calculation to cover the costs of operating our program.

Request

Amend 103A(i)(2)(A)(ii) to increase allowable spread to 1-1/4%.

b. Interest Earnings on Reserves

Mortgage revenue bonds generally have much lower debt service coverage than other revenue bonds. Therefore, appropriate reserves have been essential to assure investors of their credit worthiness. Since the reserves must be borrowed it is important that they be invested at rates sufficient to cover the cost of borrowing over the life of the reserve. The Mortgage Bond Act limits earnings allowed on the reserve funds, or if there are positive earnings, they must be returned to the mortgagors or the U. S. Treasury. We do not object to returning excess earnings. However, there are specific management problems with the Act:

1) it restricts reserves, in effect, to 150% of annual debt service. This is much more restrictive than the "reasonably required" test applying to all other tax exempt bonds.

2) it assumes, unrealistically, that reserves can be liquidated in proportion to mortgage payoffs. There is potential for substantial investment loss from a requirement that we liquidate reserves on an unscheduled basis.

3) it assumes, unrealistically, that issuers can restrict yield on investments in order to cure problems arising from attempts to comply with 1) and 2) above.

Presumably, the purpose of limiting investment earnings is to assure that the maximum benefit is passed on to the ultimate client. The restrictions of the Act, however, do just the opposite. They put the issuer in an impossible management position and call into question the self-supporting nature of the bonds. This decreases the credit-worthiness of the bonds. Therefore, bond investors will demand higher interest rates which will translate into higher mortgage loan rates. Moreover there is a substantial incentive in the Act for an issuer to deflect arbitrage profits to the private sector to create the appearance of compliance.

Request

Amend 103A(i)(3) and (4) to allow issuers more certainty in managing reserves. Most specifically, lift the limits on what an issuer may earn on investments and lift the requirement that investments be liquidated even if this produces a loss.

ISSUE 3. BOND REGISTRATION

Beginning in 1982, mortgage bonds will have to be registered. This requirement places a stigma on these bonds since they will be the only municipal bonds requiring registration. Most of the bonds are purchased by institutional investors. They will only be willing to put up with the federal paper work involved in the registration procedure if they are compensated with higher interest rates. This will mean that we will have to charge higher interest rates to the ultimate borrowers of our funds.

Request

Amend 103A(j)(1) to defer the registration requirement until it applies uniformly to all municipal bonds.

INTERIM LEGISLATION

It will be months, perhaps even a full year, before the IRS is in a position to release regulations for the Mortgage Bond Act. We therefore request that a bill immediately be introduced into Congress which would allow an agency to issue bonds if it certifies that in good faith it reasonably expects that a bond issue will meet all the requirements of Section 103A. This would perhaps allow us to move forward on an interim basis to try to implement another bond sale until such time as the IRS promulgates regulations. A copy of the proposed bill is attached.

STATEMENT TO THE SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OCTOBER 16, 1981

FROM: GRADY HAYNES
CHAIRMAN, TENNESSEE HOUSING DEVELOPMENT AGENCY

MR. CHAIRMAN, DISTINGUISHED MEMBERS OF THE SENATE FINANCE COMMITTEE -- I AM APPEARING ON BEHALF OF THE TENNESSEE HOUSING DEVELOPMENT AGENCY AND AS A PAST PRESIDENT OF THE NATIONAL LUMBER AND BUILDING MATERIALS DEALERS ASSOCIATION WITH OVER 30 YEARS EXPERIENCE IN THE OPERATION OF AN INDEPENDENT RETAIL BUILDING MATERIAL CENTER WHICH I FOUNDED IN 1951.

AS A RESULT OF THIS EXPERIENCE, I HAVE HAD A UNIQUE OPPORTUNITY TO OBSERVE HOUSING BONDS FROM SEVERAL DIFFERENT VIEWPOINTS.

THE SALE OF MORTGAGE REVENUE BONDS IN TENNESSEE IN RECENT YEARS HAS HAD A SIGNIFICANT POSITIVE ECONOMIC AND FISCAL IMPACT ON LOCAL, STATE, AND FEDERAL GOVERNMENTS.

THE TENNESSEE HOUSING DEVELOPMENT AGENCY HAS NOW SOLD $485 MILLION IN MORTGAGE REVENUE BONDS, GENERATING ECONOMIC EFFECTS WHICH INCLUDE THE FOLLOWING:

. . . INCREASED JOBS IN ALL PHASES OF THE CONSTRUCTION INDUSTRIES THAT SUPPLY CONSTRUCTION; AND

. . . INCREASED SALES AND RECEIPTS FOR WHOLESALERS, CONTRACTORS, BUILDERS, AND PROFESSIONAL SERVICE FIRMS.

THE FISCAL EFFECTS OF THESE BOND SALES INCLUDE:

. . . INCREASED PAYMENT OF FEDERAL PERSONAL AND CORPORATE INCOME TAXES:

. . . INCREASED PAYMENT OF STATE SALES AND PRIVILEGE TAXES;

. . . AND, INCREASED PAYMENT OF LOCAL PROPERTY TAXES.

THESE ECONOMIC AND FISCAL EFFECTS ARE IN ADDITION TO THE PRIMARY BENEFIT OF PROVIDING AFFORDABLE HOUSING OPPORTUNITIES TO THOUSANDS OF LOW AND MODERATE INCOME FAMILIES IN OUR STATE WHO ARE NOT TRADITIONALLY SERVED BY THE PRIVATE SECTOR.

MANY OF THESE FAMILIES WOULD NOT HAVE OTHERWISE BEEN ABLE TO OWN THEIR OWN HOME AND WOULD HAVE BECOME A BURDEN ON PUBLIC HOUSING OR OTHER SUBSIDIZED PROGRAMS.

THE INABILITY OF HOUSING FINANCE AGENCIES TO SELL BONDS HAS BEEN A MAJOR CONTRIBUTING FACTOR TO THE EXTREMELY LOW VOLUME OF 1981 HOUSING STARTS IN OUR COUNTRY.

DURING 1979 AND 1980, ABOUT $9.5 BILLION IN HOUSING BONDS WERE ISSUED EACH YEAR TO FINANCE THE PURCHASE OF SINGLE FAMILY HOMES FOR LOW AND MODERATE INCOME FAMILIES AND, AND BY THIS TIME LAST YEAR, OVER $8 BILLION OF THESE BONDS HAD BEEN ISSUED.

HOWEVER, SO FAR THIS YEAR, THE TOTAL IS VIRTUALLY ZERO -- EVEN THOUGH THE COMBINED ALLOCATION PERMITTED BY THE MORTGAGE SUBSIDY BOND TAX ACT FOR ALL STATES TOTALED APPROXIMATELY $15 BILLION. THIS WOULD FINANCE THE PURCHASE OF APPROXIMATELY 300,000 HOMES (NEW AND EXISTING) -- AFTER THE PRICE RESTRICTIONS UNDER THE NEW ACT ARE APPLIED.

THE TOTAL IMPACT OF BOND-FINANCED LOANS ON THE HOUSING INDUSTRY WILL BE EVEN GREATER THAN THE NUMBERS INDICATE BECAUSE MANY OF THESE LOANS WILL BE USED TO FINANCE A SALE OF LOW PRICED EXISTING HOMES -- RELEASING THE EQUITY THAT HAS ACCUMULATED BY THE PRESENT OWNER.

THIS EQUITY, IN TURN, WILL BE USED TO PURCHASE A BETTER USED HOME, OR A NEW HOME, THEREBY INCREASING THE SALE OF HOMES IN ALL PRICE CATEGORIES.

THE VERY LARGE DOLLAR VOLUME OF EQUITY RELEASED FROM THE SALE OF EXISTING HOMES IS OFTEN OVERLOOKED BY ECONOMISTS AND ITS EFFECTS ON THE HOUSING INDUSTRY HAVE BEEN GREATLY UNDERESTIMATED.

RECOGNIZING THE IMPORTANCE OF HOUSING BONDS TO OUR STATE, OUR AGENCY HAS MADE A DETERMINED -- BUT THUS FAR UNSUCCESSFUL EFFORT TO ISSUE BONDS UNDER THE SEVERE RESTRICTIONS PLACED ON SUCH AN ISSUE BY THE MORTGAGE SUBSIDY BOND TAX ACT OF 1980.

ON APRIL 16 OF THIS YEAR OUR AGENCY MADE APPLICATION TO IRS FOR A RULING ON A PROPOSED PLAN OF FINANCING.

TO GIVE YOU SOME IDEA OF THE COMPLEXITIES OF TRYING TO MEET THE REQUIREMENTS OF THESE NEW FEDERAL REGULATIONS -- I WOULD LIKE TO SHOW YOU MY COPY OF THIS APPLICATION -- WHICH MEASURES 2 1/2 INCHES

I SUBMIT THAT THESE NEW FEDERAL REGULATIONS REPRESENT A CLASSIC EXAMPLE OF OVER-REGULATION ON THE PART OF THE FEDERAL GOVERNMENT. TO CONTROL THE USE OF HOUSING BONDS, ALL THAT WAS NECESSARY WAS A SIMPLE BILL THAT WOULD ESTABLISH AN ALLOCATION FOR EACH STATE AND DEFINE WHO WOULD BE ELIGIBLE TO PARTICIPATE -- AND LEAVE THE IMPLEMENTATION DETAILS TO THE INDIVIDUAL STATES. SUCH A BILL WAS INTRODUCED LAST FALL BY SENATOR SASSER.

I WOULD LIKE TO FURTHER POINT OUT THAT THE ADDITIONAL COST FOR COMPLYING WITH THESE NEW AND UNNECESSARY REGULATIONS ARE PASSED ALONG TO THE HOME BUYER IN THE FORM OF HIGHER INTEREST RATES -- EVEN THOUGH THE SUBSIDY COST TO THE FEDERAL GOVERNMENT REMAINS EXACTLY THE SAME.

BY THE WAY, THIS SUBSIDY COST WILL NOW BE SIGNIFICANTLY REDUCED BECAUSE THE MAXIMUM TAX BRACKET HAS BEEN REDUCED TO 50 PERCENT.

PURSUING OUR EFFORTS TO ISSUE BONDS, WE WERE ADVISED BY IRS THE FIRST WEEK IN AUGUST THAT THEY HAD STARTED WORK ON OUR APPLICATION WHICH CULMINATED IN A HEARING IN THEIR OFFICE HERE IN WASHINGTON ON SEPTEMBER 2.

AT THE HEARING, THE IRS WAS ABLE TO CLARIFY MANY OF THE REGULATIONS THAT WERE ISSUED IN JUNE.

HOWEVER, THEY WERE UNABLE TO SATISFACTORILY DEAL WITH THE 95 PERCENT STRICT COMPLIANCE REQUIREMENT.

AS A CONSEQUENCE, OUR BOND COUNSEL HAS BEEN UNABLE TO ISSUE AN UNQUALIFIED OPINION THAT BONDS ISSUED UNDER THIS NEW LAW WOULD REMAINS TAX EXEMPT.

AT THE PRESENT TIME WE ARE ADVISED BY OUR BOND UNDERWRITERS THAT IT WOULD BE DIFFICULT -- IF NOT IMPOSSIBLE -- TO SUCCESSFULLY MARKET OUR BONDS WITH A QUALIFIED OPINION -- EVEN THOUGH HEAVILY SUBSIDIZED BY OUR AGENCY.

EVEN IF THEY COULD BE SOLD, THE PRICE OF THE BONDS WOULD BE SUBSTANTIALLY LOWER, THEREBY, INCREASING THE MORTGAGE RATE TO THE LOW AND MODERATE INCOME FAMILIES WE ARE ATTEMPTING TO SERVE.

THE ONLY REASONABLE OPTION OPEN TO OUR AGENCY, AS WELL AS ALL OTHER HOUSING FINANCE AGENCIES IN THE COUNTRY, IS TO WAIT UNTIL CONGRESS PASSES THE "CLEAN-UP BILL" BEING CONSIDERED HERE TODAY.

I HAVE WITH ME TODAY OUR BOND COUNSEL ATTORNEY, MR. PAUL A. DEBARY, WHO IS CHIEFLY RESPONSIBLE FOR THE LANGUAGE IN S. 1348. HE WILL BE AVAILABLE AT THE CONCLUSION OF MY REMARKS TO ANSWER ANY TECHNICAL QUESTIONS YOU MAY HAVE.

FOR YOUR FURTHER INFORMATION, A DETAILED EXPLANATION OF WHAT IS CONTAINED IN S. 1348 BY MR. DEBARY IS ATTACHED TO MY WRITTEN TESTIMONY WHICH HAS BEEN SUBMITTED TO THIS COMMITTEE.

IN HIS EFFORTS TO MAKE SURE THAT THIS BILL WOULD ENABLE BOND COUNSEL FIRMS TO ISSUE AN UNQUALIFIED OPINION ON THE TAX EXEMPT STATUS OF BONDS ISSUED UNDER THIS NEW LAW, PAUL CONSULTED WITH OTHER BOND COUNSEL ATTORNEYS FROM HIS OWN FIRM AS WELL AS SEVERAL OTHER BOND COUNSEL FIRMS.

HE ALSO CONSULTED WITH STAFF ATTORNEYS FROM THE SENATE FINANCE COMMITTEE, THE HOUSE WAYS AND MEANS COMMITTEE, THE JOINT COMMITTEE ON TAXATION, AND WITH CONGRESSMAN JOHN DUNCAN, WHO INTRODUCED THE COMPANION TO THIS BILL.

IN SUMMARY, THIS BILL WILL NOT ONLY MAKE IT POSSIBLE TO ONCE AGAIN ISSUE HOUSING BONDS BY CLARIFYING THEIR TAX-EXEMPT STATUS -- BUT WILL ALSO REDUCE INTEREST COST TO THE HOME BUYER BY MAKING IT EASIER AND LESS EXPENSIVE TO COMPLY WITH THEIR REGULATIONS.

MAY I RESPECTFULLY URGE THAT THIS COMMITTEE RECOMMEND S. 1348 BE ENACTED BY THE FULL SENATE AT THE EARLIEST POSSIBLE DATE -- WITHOUT AMENDMENTS OR DELETIONS.

I APPRECIATE THE OPPORTUNITY TO BE HEARD AT THIS MEETING AND PAUL AND I WILL BE HAPPY TO ATTEMPT TO ANSWER ANY QUESTIONS THE COMMITTEE MAY HAVE.

STATEMENT SUMMARY OF GRADY HAYNES

CHAIRMAN, TENNESSEE HOUSING DEVELOPMENT AGENCY

BEFORE SENATE FINANCE SUBCOMMITTEE

ON TAXATION AND DEBT MANAGEMENT

OCTOBER 16, 1981

-- The sale of mortgage revenue bonds in Tennessee has had significant positive impact on low and moderate income homebuyers and on local, state, and federal governments.

  --primary benefit is affordable housing opportunities to low and moderate income families not traditionally served by the private sector.

  --economic and fiscal effects of MRB sales include the following: increased jobs and sales, and increased payment of local, state and federal taxes.

-- The inability of housing finance agencies to sell bonds has been a major contributing factor to the extremely low volume of 1981 national housing starts.

-- New federal regulations under the Mortgage Subsidy Bond Tax Act add costs that are passed along to the homebuyer in the form of higher interest rates.

-- The inability of IRS to deal satisfactorily with the 95 percent strict compliance requirement renders bond counsel unable to issue an unqualified opinion on tax-exempt status of bonds issued under the 1980 law.

-- Tennessee Housing is advised by bond underwriters that it would be difficult--if not impossible--to successfully market its bonds with a qualified opinion, even with a heavy Agency subsidy.

-- The only reasonable option open to THDA, as well as all other housing finance agencies in the country, is to look to Congress for relief through passage of S1348/HR3614.

STATEMENT TO THE SENATE FINANCE SUBCOMMITTEE

ON

TAXATION AND DEBT MANAGEMENT

OCTOBER 16, 1981

FROM: Grady Haynes, Chairman of the Tennessee Housing Development Agency

Mr. Chairman, distinguished members of the Senate Finance Committee -- I am appearing on behalf of the Tennessee Housing Development Agency and as a past president of the National Lumber and Building Materials Dealers Association with over 30 years experience in the operation of an independent retail building material center which I founded in 1951. In order to survive in our highly competitive industry, it was necessary for me to become involved in the supply of mortgage money for our customers. With this motivation, I participated in the successful organization of a new savings and loan association in our community and was involved in all phases of its operation for 5 years. In 1973, as president of the Tennessee Building Materials Association, I had the opportunity to assume a leadership role on behalf of the association in obtaining the passage of the enabling legislation creating the Tennessee Housing Development Agency. I was appointed by Governor Dunn to serve on the original board of directors of the newly formed agency and during my 3 year term in office I played a very active part in the agency's organization and the implementation of its very successful single-family home ownership program. For the past 2 years, I have served as chairman of the agency --

having been appointed to that post by our present governor, Lamar Alexander. As a result of these experiences, I have had a unique opportunity to observe housing bonds from several different viewpoints. The sale of mortgage revenue bonds in Tennessee in recent years has had a significant positive economic and fiscal impact on local, state, and federal governments. The Tennessee Housing Development Agency has now sold $485 million in mortgage revenue bonds, generating economic effects which include the following: increased jobs in all phases of the construction industry and in the other industries that supply construction; increased sales and receipts for wholesalers, contractors, builders, and professional service firms. The fiscal effects of these bond sales include: increased payment of federal personal and corporate income taxes; increased payment of state sales and privilege taxes; and increased payment of local property taxes.

These economic and fiscal effects are in addition to the primary benefit of providing affordable housing opportunities to thousands of low and moderate income families in our state who are not traditionally served by the private sector. Many of these families would not have otherwise been able to own their own home and would have become a burden on public housing or other subsidized programs.

All of you are acutely aware of the severe problems facing the housing industry at this time. However, I think that the figures released a few days ago by the Metro Codes Administration for Nashville and Davidson County dramatically emphasize the disastrous effect that high interest costs has had on housing in that county — which is one of the most prosperous counties in Tennessee. Their figures show that only eleven permits were issued during the month of September for single family homes. This compares with 133 such permits in September of 1980, 104 in the same 1979 period, 141 in September of

1978. When multi-family permits are added to the total permits for residential units -- this total new construction will only accommodate 48 families. This compares with permits for 238 family units last September. Although this drop in construction may not be as severe in many other parts of the country, I am sure that the National Association of Home Builders will testify that the situation nationwide is indeed critical.

The inability of housing finance agencies to sell bonds has been a major contributing factor to the extremely low volume of 1981 housing starts in our country. During 1979 and 1980, about $9.5 billion in housing bonds were issued each year to finance the purchase of single family homes for low and moderate income families and, by this time last year, over $8 billion of these bonds had been issued. However, so far this year the total is virtually zero -- even though the combined allocation permitted by the Mortgage Subsidy Bond Tax Act for all states totalled approximately $15 billion. This would finance the purchase of approximately 300,000 homes (new and existing) -- after the price restrictions under the new act are applied.

The total impact of bond financed loans on the housing industry will be even greater than the numbers indicate because many of these loans will be used to finance a sale of low priced existing homes -- releasing the equity that has accumulated by the present owner. This equity, in turn, will be used to purchase a better used home, or a new home, thereby increasing the sale of homes in all price categories. The very large dollar volume of equity released from the sale of existing homes is often overlooked by economists and its effects on the housing industry have been greatly underestimated.

Recognizing the importance of housing bonds to our state, our agency has made a determined — but thus far unsuccessful effort to issue bonds under the severe restrictions placed on such an issue by the Mortgage Subsidy Bond Tax Act of 1980. On April 16 of this year our agency made application to IRS for a ruling on a proposed plan of financing. To give you some idea of the complexities of trying to meet the requirements of these new federal regulations — I would like to show you my copy of this application — which measures 2 ½ inches thick.

I submit that these new federal regulations represent a classic example of over regulation on the part of the federal government. To control the use of housing bonds, all that was necessary was a simple bill that would establish an allocation for each state and define who would be eligible to particpate -- and leave the implementation details to the individual states. Such a bill was introduced last fall by Senator Sasser.

I would like to further point out that the additional cost for complying with these new and unnecessary regulations are passed along to the home buyer in the form of higher interest rates -- even though the subsidy cost to the federal government remains exactly the same. By the way, this subsidy cost will now be significantly reduced because the maximum tax bracket has been reduced to 50%. Pursuing our efforts to issue bonds, we were advised by IRS the first week in August that they had started work on our application which culminated in a hearing in their office here in Washington on September 2. The net result was that even though the regulations which were finally issued in June by the Treasury Department -- combined with a careful review by IRS of our application served to clarify many of the technical problems — they were unable to deal with one of the most major conceptual changes brought about by the new law -- namely, the 95% strict compliance requirement. As a consequence, our bond counsel has been unable to issue an unqualified opinion that bonds issued under this new law would remain tax exempt.

At the present time we are advised by our bond underwriters that it would be difficult -- if not impossible to successfully market our bonds with a qualified opinion -- even though heavily subsidized by our Agency. Even if they could be sold, the price of bonds would be substantially [illegible] ~~lower~~ [illegible] thereby increasing the mortgage rate to the low and moderate income families we are attempting to serve. The only reasonable option open to our agency as well as all other housing finance agencies in the country is to wait until Congress passes the "Clean-up Bill" being considered here today.

I have with me today our bond counsel attorney, Mr. Paul A. deBary, who is chiefly responsible for the language in S 1348. He will be available at the conclusion of my remarks to answer any technical questions you may have. For your further information, a detailed explanation of what is contained in S 1348 by Mr. deBary is attached to my written testimony which has been submitted to this committee.

In his efforts to make sure that this bill would enable bond counsel firms to issue an unqualified opinion on the tax exempt status of bonds issued under this new law, should this bill pass, Paul consulted with other bond counsel attorneys from his own firm as well as several other bond counsel firms. He also consulted with staff attorneys from the Senate Finance Committee, The House Ways and Means Committee, The Joint Committee on Taxation, and with Congressman John Duncan who introduced this bill (HR 3614) in the

House of Representatives on May 19, 1981. Input into this bill was also made by the Council of State Housing Agencies whose Board of Directors has unanimously endorsed this legislation.

In summary, this bill will not only make it possible to once again issue housing bonds by clarifying their tax-exempt status -- but will also reduce interest cost to the home buyer by making it easier and less expensive to comply with their regulations. May I respectfully urge that this committee recommend S 1348 be enacted by the full Senate at the earliest possible date -- without amendments or deletions. I appreciate the opportunity to be heard at this meeting and Paul and I will be happy to attempt to answer any questions the committee may have.

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October 15, 1981

Mr. Grady R. Haynes, Chairman
Tennessee Housing
Development Agency
706 Church Street
349 Doctors Building
Nashville, Tennessee 37203

Re: Proposed Amendments to the Mortgage Bond Provisions of the Omnibus Reconciliation Act of 1980

Dear Grady:

In connection with your testimony tomorrow, this letter reviews possible amendments to the mortgage bond provisions of the Omnibus Reconciliation Act of 1980. The adoption of these provisions, in the form of Section 103A of the Internal Revenue Code, has created an entirely new set of rules with which an issuer must comply in order to issue tax exempt housing bonds. We believe that Congress did not fully appreciate the practical effect of many of these rules and the degree to which they jeopardize the feasibility of issues. The amendments are intended to improve the ability of housing finance agencies to issue bonds pursuant to its provisions.

The apparent intent of Congress in adopting the new rules was to limit the total amount of single-family housing bonds being issued and to target the funds derived from those permittted to be issued toward certain purposes. However, due to the manner in which this was done, local governments now face an unprecedented intrusion by the federal government in the day to day administration of programs by housing finance agencies which are financed with tax-exempt bonds. It does not appear that many of the most onerous results of the new rules are necessary in order to achieve the original intent of Congress. It is likely that many of these results were unintentional by-products of dealing with mortgage revenue bonds as part of the pressured and confused budget reconciliation process that ended the 96th Congress.

The amendments which are the subject of this memorandum are incorporated in bills which have been introduced in both the Senate (S. 1348) and the House (H.R. 3614). Both Bills are referred to in this memorandum as the "Bill". We were requested to participate in the original drafting of these bills by our client, the Tennessee Housing Development Agency, in order to assist them in continuing their Homeownership Loan Program.

In order to continue this program the Agency must be able to structure a marketable issue. Even an issuer which is prepared to dedicate substantial outside funds to support the issue from a credit standpoint must be able to provide investors with assurances against unusual future risks which would have a material adverse affect on its bonds. In addition, the Agency believed that burdensome, inconsistent and impractical requirements which do not seem to further the original intent of Congress should be eliminated.

The following is our view of the purpose and intent of the amendments made by the Bill in order to address these problems:

a. Good Faith Requirments. Congress apparently intended to permit agencies to evidence compliance with the new restrictions on mortgage revenue bonds based on their good faith efforts. However, the provisions of Subparagraphs (B) and (C) of Paragraph 103A(c)(2) of the Code actually impose a high strict compliance standard. Thus, clause 103A(2)(B)(ii) requires actual compliance by 95% of the mortgages irrespective of the good faith efforts of the issuer, while clause 103A(c)(2) excuses only "inadvertent errors" notwithstanding the issuer's good faith.

Because of the number and complexity of the new requirements, there is a good possibility that errors will occur. It has, therefore, been difficult to assure the market that the bonds will be tax-exempt and to secure traditional opinions of counsel as to their tax-exempt nature under these provisions. In addition, the new rules require compliance on an ongoing basis throughout the life of the bonds. This raises the possibility that the bonds will, without notice, become taxable in the hands of an innocent holder after they are outstanding for a period of time.

The proposed amendments contained in subsections (a). and (b) of the Bill remove the strict compliance standard and rely solely on the good faith efforts of the issuer. In addition, these amendments permit a purchaser of the bonds to rely on a covenant by the issuer to comply with the new rules.

b. Prior Residency. Section 103A limits eligible mortgagors to persons who have had no ownership interest in a principal residence for three years. A number of questions have arisen concerning the application of this rule to mobile homeowners and others. Of particular concern is the impact that this has on persons in many states, such as Tennessee, where substantial numbers of persons live in sub-standard housing, which they own.

The amendment suggested in subsection (c) of the Bill allows an issuer to finance the move of a homeowner who is moving from sub-standard housing to housing which meets the issuers' minimum property standards or the move of a homeowner who has been displaced by natural disaster or governmental action.

c. Purchase Price Limits. Section 103A establishes a complex set of purchase price limits on the homes to be financed. Unfortunately, the statistics which the provisions require to be used to determine these limits are not readily available. The proposed amendment contained in subsection (d) simplifies the purchase price limits to reflect available data.

The proposed amendment reflected in subsection (g) of the attached draft permits the issuer to use earnings to offset the loss or continue to hold the investment until it may be liquidated without a net loss.

(iv) PROGRAMATIC COMPLIANCE -- In order to relive issuers of the burden of making separate calculations for each individual bond issue and to allow them to offset losses from one issue against gains on another, the amendments in subsection (h) allow an issuer to comply with the requirements of Section 103(i) of the Code on a programatic basis. This is extremely important for issuers such as state housing finance agencies who typically have used open ended indentures and issued several series of bonds on a parity basis. The imposition of the 103A requirements on an issue-by-issue basis would take away much of the value of issuing bonds on this basis since the availability of funds would not reflect the overall performance of the issue.

e. Assumption Restrictions. Most housing finance agencies restrict assumptions to persons qualified under their programs. This requirement has been waived in the case of FHA and VA loans, however, because of a long standing federal policy not to restrict assumptions. Under the new provisions of the Code, FHA and VA loans could not be made unless this policy were to change. A majority of THDA's loans have in the past been FHA or VA loans. In order to allow these to continue to be part of the program the amendment reflected in subsection (j) of the Bill creates an exception for FHA and VA loans.

f. Targeted Areas. In order to establish targeted areas under the new rules an issuer must obtain approval from the Secretary of the Treasury and the Secretary of HUD. This continuing entanglement between local housing issuers and the federal bureaucracy seems unnecessary in light of all the other restrictions in the new rules. Subsection (k) of the Bill allows States to establish targeted areas without review by the U.S. Treasury and HUD. To reassure those who suspect that a State would then target its entire geographic area a 25% limit is adopted. In addition, the proposal adopts as targeted areas those areas designated as energy impacted areas under 42 U.S.C. §8401(a).

d. Arbitrage Restrictions. Section 103A creates a new class of tax-exempt obligations which have been singled out for discriminatory arbitrage treatment. Thus, housing issuers must comply with restrictive and complex arbitrage rules which do not apply to any other tax-exempt issuer. Tax-exempt issuers financing business loans, student loans, farming loans, golf courses, parking garages, or any other activity or facility but housing, are required only to comply with the general arbitrage rules contained in subsection 103(c) of the Code.

The proposed amendments in subsections (e), (f), (g) and (k) of the Bill attempt to restore housing issuers to a position more equal to that of other tax-exempt issuers. This has been done with a minimum of changes to the existing legislation. Where the new rules could be viewed as clarification of areas which were ambiguous under the existing law, they have not been changed. However, the most onerous and discriminatory provisions have been addressed as follows:

(i) SPREAD -- All other governmental programs are permitted a 1 1/2% "spread" between the yield on the bonds and the yield on the obligations acquired with the proceeds. The new rules limit this to 1%. At this time, the only issuers who have been able to market issues under the new limitation on spread are those who can afford to commit substantial outside funds to support the issue. Subsection (e) of the Bill restores the 1 1/2% limitation.

(ii) PREPAYMENTS -- The rules require an issuer to compute the yield on its mortgages and its bonds on the basis of certain prepayment statistics compiled (for other purposes) by FHA. These statistics are not only totally unrealistic as a basis for predicting an issuer's actual experience, but result in gross distortions when applied to most state housing agencies, which recycle mortgage loan prepayments. The amendment proposed in subsection (f) clarifies that this requirement does not apply to recycled mortgages. (Issuers will still be required to compute yield based on their reasonable expectations as to prepayments under the general rules).

(iii) RESERVES -- The provisions of paragraph (103A(i)(3) of the Code now place an issuer in a position where it may be forced to liquidate investments at a substantial loss even if this would result in a default of the bonds. Oddly, this may occur even when the issuer has available substantial amounts of investment earnings (which are required to be distributed to mortgagors under the new rules).

COUNCIL OF STATE HOUSING AGENCIES

PREPARED STATEMENT OF
RICHARD K. HELMBRECHT, PRESIDENT
COUNCIL OF STATE HOUSING AGENCIES
FOR THE
SENATE FINANCE SUBCOMMITTEE
ON
TAXATION AND DEBT MANAGEMENT
OCTOBER 16, 1981

By way of introduction, I am Richard K. Helmbrecht, President of the Council of State Housing Agencies. I am also Executive Director of the Michigan State Housing Development Authority and a member of the President's Commission on Housing. The Council currently has 52 member State Housing Finance Agencies (HFAs) as well as 150 organizations affiliated with the Council, including builders, developers, investment bankers and others involved with state housing finance agencies.

Before proceeding, a brief overview of our testimony is appropriate.

First, we point with pride to the successful state agency Mortgage Revenue Bond programs. These include home ownership, multifamily rental housing, home improvement and energy loan programs, rehab, new construction, subsidized and non-subsidized programs.

Second, we will outline the problems created by the Mortgage Subsidy Bond Act of 1980. These problems have resulted in the 1981 bond volume being less than 1% of that projected under the Omnibus Budget Reconciliation Act of 1980.

This Treasury Department's $10 billion dollar projection would finance homes for 180,000 first time homebuyers, and trigger the sale of 400,000 homes. Over 2 billion dollars in tax revenue would have been generated and 300,000 jobs created. All for a cost to the Treasury that already has been budgeted and is assumed to be $300 million dollars.

Third, we will comment on solutions to these problems, both as to the legislation and as to regulation.

The Role of State Housing Finance Agencies

We believe that an accurate understanding of the state agency assisted housing development process will enhance the Subcommittee's evaluation of our testimony.

State housing finance agencies are created by state enabling legislation to assist in the financing of housing for persons and families of low and moderate income within their state. They do not build for themselves, rather, they lend money to the private sector for the public purpose of providing housing for families who can't be served by the private sector without government assistance.

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While the mix of loan programs vary from agency to agency, state agencies have provided both multi-family project financing and single-family mortgages and have addressed many areas with innovative new programs. The agencies finance their programs by selling tax-exempt notes and bonds in the national capital markets, and lending bond proceeds to developers or to low and moderate income families seeking mortgages. Many of these programs have been accomplished in conjunction with the U.S. Department of Housing and Urban Development, forming a vital link between federal dollars and private accomplishments in the housing area. As a rule, state agencies are self-supporting, raising the money they need from fees and charges associated with the loans.

The Need for Mortgage Revenue Bonds

In discussing the complicated and often confusing provisions of the Mortgage Subsidy Bond Act of 1980, I believe that it is important that we not be diverted from the main issue, affordability of housing. Along with hundreds of other housing professionals, I have been substantially diverted for 2-1/2 years from my focus on housing programs. Instead my staff and I have spent thousands upon thousands of hours trying to make sense out of the Mortgage Subsidy Bond Act.

At this time, the need for affordable housing financing has intensified. In 1970, few housing prognosticators could have imagined the range of developments in the housing sector during the coming decade. At that time, a new home cost about $23,000 with interest rates in the 8% range. During the decade, new home prices increased by over 250% and mortgage interest rates rose to 15% and above. Since median family revenue rose by only 213% during the same period, the median income family who could afford the median priced home in 1970, now cannot. By 1980, only about 15% of all families could afford the median priced home.

New mortgage financing techniques and double wage earner households will keep home ownership within reach of many middle income households, however, most moderate and all low income households will be priced out of the market.

Rental housing is also not an alternative. Rental housing production (starts) dropped from 541,000 units in 1979 to 397,000 units from 1980 with 50% of the 1980 starts being government subsidized. Vacancy rates are as low as 1% in many areas.

Yet demand continues to build. About 17 million new households will be formed and 24.5 million units will be needed in the 80s. Mortgage revenue bond programs are necessary to meet this need by making housing affordable to those otherwise priced out of the market. The legitimate public purpose of these bonds has been demonstrated in the past. A 1979 survey determined that over 75% of the loans made by the agencies' surveyed were for first time homebuyers. Average incomes were well below statewide median incomes. According to the survey, the average sales price was $33,642, the average purchaser's income was $14,399 and the average mortgage amount was $30,583.

The Nature of the Problem

The basic thrust of the 1980 Act was to limit the volume of bonds thus saving on projected tax loss, to target the use of the bonds to avoid abuse, and to define the structuring of bond issues to reduce fees and other payments which some claim tended to make the bonds inefficient.

The practical impact of the Act was to create such confusion that issues could not proceed before regulations were issued, and the single-family regulations when issued were so restrictive that they have rendered programs unfeasible. Multi-family regulations still have not been issued and we fear the worst.

Our outrage can be easily understood. In April of 1979 the Ullman bill was introduced with a retroactive effective date. Due to the nature of the bond market, the retroactive provisions effectively ended single family program issues. Congress was then beseiged by issuers, and potential issuers, who wanted at least one shot. Permanent housing agencies, city and state, which had been effectively issuing the bonds for valid public purposes, were shunted aside as one shot transition rules were traded in Congress. The discussion of an effective, fair, permanent rule became secondary to the immediate need to satisfy short term demands.

The Council of State Housing Agencies watched with amazement as their proven programs which were well targeted and had statewide availability received a $150 million transition rule, and towns and counties with limited populations and no targeting received $200 million or more because of the legislative trade-offs.

Ultimately, through a new process, the "reconciliation" process, the Act we now have was adopted without hearings on the specific provisions. Hearings were held in the Senate (in the Intergovernmental Committee not Finance) and in the House (before the actual language was available), but not on the actual provisions now in the law.

The legislation was then given to a Treasury Department in transition which could not effectively focus on the issues at the policy level due to other demands.

The result is a complicated package of law and regulation which may have been written to work, but which doesn't. In short, the Act and the Regulations represent the worst kind of federal overkill. The problems are purely legislative, purely regulatory or a combination of both. Overall, the new requirements, when taken together, make simple and effective programs complicated and costly, if possible at all.

The Solution

Our ideal solution would be to ask for repeal of the Act and a new beginning. Many of our members effectively argue that interference with a States' ability to raise revenue through the issuance of securities is unconstitutional. Many at the Federal level also seem to share these concerns as new proposals to limit the use of other revenue bond programs are based on methods other than direct prohibitions. The Act substitutes federal program judgement for state judgement. State agencies, which had not been subject to charges of abuse, must now ask Washington how to proceed, if, indeed, we may proceed at all. Last year we supported a volume cap while allowing the state legislative process the authority to determine the use of proceeds. That is a much fairer and reasonable approach than the federal intervention process adopted.

We are practical, however, and this year we are seeking narrow changes to make last years act workable. We are asking for legislation only after seeking workable regulations. We must be candid. The act is so complex that the regulators can virtually stop or start the program. Although the legislation is generally complicated and restrictive, we believe the Treasury Department could have fulfilled the Congressional intent to limit but not prohibit bond issues and could have made the legislation workable. They chose not to do so. As a result of their overreaction in their regulations, and the delay in promulgation we are left with no alternative except legislation.

We recognize that Congress has little time or patience to rehear all the Mortgage Bond issues. Thus, we request clarification of several main issues impacting the feasibility of issues, and a congressional direction that Treasury simplify and clarify other requirements. The changes we request are consistent with the President's budget calculations. The proposals, as set forth in Senator Sasser's S1348, have been found by the Joint Tax Committee to have no budgetary impact.

When we use the term feasible or workable we do not mean that issues will not "dribble out" under present law. With enough resources behind an issue in the form of equity, and a willingness to pay a high interest rate and limit volume, some issues will be forthcoming. This will, however, create an inequitable situation. Issuers with cash on hand or with higher income homebuyers willing to absorb higher interest costs may be able to go forward, but others with greater need and more targeted programs will not.

Either way, what was intended to be a $10 billion dollar program will be significantly reduced at a time when the housing industry is at its lowest productive capacity since 1946. The noninflationary market stimulus of the activation of the mortgage revenue bond program will re-employ thousands of workers and more than pay for itself in taxes generated at the federal, state, and local level, and in the reductions in federal benefit programs. Further, we seek redress so that the time and effort of hundreds of individuals might be spent productively meeting our real housing needs, not in meeting the artificial complexities of the Act.

The Specific Solution

The Council of State Housing Agencies has endorsed the legislation sponsored by Senators Sasser and Baker of Tennessee and over 30 other Senators. The Council also has endorsed the intent of Senator Durenberger's bill which correctly identifies the principal concerns we are seeking to resolve this year. With legislation as complicated as this law, and with the varying nature of different state and local programs, many important concerns will be brought to the committee's attention. Our principal concerns, however, must be clearly stated because without redress of these, little else will matter. First we have several threshold problems:

> Arbitrage and Yield Limits. No other issue causes as much fervor and confusion as what is commonly known as arbitrage. In short, this area involves those restrictions of the Act which impact on the allowable uses of income from mortgage loan programs for payment of the costs of the program. Income from the program, whether it is generated by a mark up in interest rates over borrowing costs, by upfront fees paid by the borrower, or from the investment of reserves or other cash on hand, must be sufficient to pay for program expenses and guard against reasonable and prudent risks. At the time the Act was passed a chief concern was how to limit what was perceived as unnecessarily high fees to underwriters and consultants and the windfall arbitrage profits being earned by issuers. There may have been some merit in these concerns and we do not object to reasonable limits, however, the approach taken is both confusing and costly. It is costly to issuers in that administrative costs are dramatically increased and costly to borrowers in that interest costs will be higher.

The Act made dramatic changes in existing law in the area of arbitrage and yield:

1. It changed the maximum annual override from 1.5% to 1%.
2. It required that costs of issuance (i.e. underwriters' fees, bond counsel fees, and other necessary expenses) be paid for by an issuer from the 1% override limitation. These expenses were previously recoverable outside of the old 1.5% limit.
3. It limited earnings on reserves and temporary funds and required that earnings in excess of the interest rate be rebated to the borrowers or the federal government. Previously these funds were retained by the issuer.

The sum of these actions was to reduce effective income by 2/3's, while depleting reserves which added security and reduced interest rates.

The only thing that I can say with certainty about these arbitrage and yield limitations is that the complexities are such that in many instances they have the reverse of the intended effect. Speaking from personal experience, Michigan has run into a half dozen situations where the preferable and less expensive solution is precluded by the provisions of the Act, necessitating the more expensive required solution. I am certain that this is not what you intended.

Many will oppose change in the yield requirement as they fear abuse, large fees, or agency enrichment. We protest these fears as it suggests that responsibility will be present only if there is federal involvement, yet no one has pointed to state abuses.

In a separate addendum we present the State Agency technical case for change in the yield requirement. We request the opportunity to administer our own program as we did successfully for years. We have always believed in a concept that is only currently gaining favor in Washington, that is, that the federal bureaucracy is not the only governmental process which can work for the public betterment. Our requests are not exorbitant; particularly when compared to comparable markups by conventional financial institutions of 3% per year plus sizeable upfront fees. Our calculations and other analysis presented to us indicate that depending on the size and purpose of the program, a total yield of somewhere between 1.25% and 1.40% is sufficient. Please note that this allowable yield includes all upfront fees and must pay for all expenses including costs of selling the bonds. We have presented our data. Please review it carefully. While we believe the numbers speak for themselves, please consult with us if you have any questions or concerns. The new act is complicated and funds must be available to manage and to fund risk.

The 95% Test. What is commonly known as the 95% test is the legislative proviso that 95% of the proceeds must be invested in eligible loans. This test must be met at the time the mortgages were executed. This requirement is in addition to the requirement that the issuer, in good faith attempt to meet all requirements and correct any failure within a reasonable period. This three part requirement, as interpreted by the Treasury is clearly overkill. First, it makes the issuer fatally responsible for events beyond its control, i.e. fraud, misstatement, mistake or even a misunderstanding, even if the issuer took all prudent and reasonable steps to comply. Second, it changes the whole enforcement concept previously utilized in the bond issuance area, for it allows events that occur after the issuance of the bonds to lead to the retroactive removal of tax exemption. Third, it takes what was a relatively simple program and makes it so complex that the senior program staff, attorneys, bond counsel, and underwriters who have been working this regulation for almost one year have a hard, if not impossible, time implementing and interpreting it. However, these are not the people who will be making the decisions on each individual loan. For instance, in Michigan, we have over 50 lenders, many with multiple offices, who will be our front line troops in explaining this Act's provisions. The Act's sheer complexity gives me serious doubts as to how successful they will be.

The solution in the Sasser legislation is to rely on good faith at the time of issue, the Durenberger approach suggests audit and fraud requirements. We understand the need for some requirements to insure that the issuer enforces the intent of the law. The Council prefers a good faith and certification procedure as being sensible and efficient. We do not object to other tests if they result in a clean opinion and are administratively sensible.

Loss on Reserves. The regulations and legislation result in a situation wherein a financially healthy issue could be put in danger by the need to reduce reserves at the time of prepayment of mortgages, even when the large volume of prepayments could not have been predicted. These reserves are invested in fixed income securities and to sell them prior to maturity may mean selling at a loss. This should and could be easily corrected by regulation or by legislation.

Registration. We object to the legislative requirement to register both ownership and rental bonds. This clearly singles out housing bonds since virtually no other bonds have this requirement. The provision will prove costly to programs designed to reach lower income people. We again ask that the registration of housing bonds be eliminated until a decision is reached on the registration of all municipal bonds.

Multi-family. We face basic problems in rental housing bond requirements. As noted, multifamily regulations still have not been issued. We fear the worst, and we believe that several problems could and should be eliminated without waiting for regulations. First, the income limits are established by cross references to other programs. There should be a a direct reference made to the 80% median income test presently required. Second, the ambiguity in the term of the income occupancy requirement, and the relationship of the occupancy term to the bond term, should be clarified. We suggest that the term of the low income occupancy requirement be set at the greater of 10 years or 50% of the maximum term of the bonds used to finance the project. We view this as a minimum position. We support a reduction in the percentage of low income to something less than the present 20%, but we again are pragmatic. We need immediate change and we are willing to compromise.

We see on the horizon an ever increasing rental housing problem. Congress has reduced and will continue to reduce direct subsidy programs for rental housing. Tax law still favors home ownership, and depreciation benefits are nowhere near enough to result in sufficient housing production for low and moderate income families. Tax exempt financing is a must if we are to meet rental housing needs. To this end we also see the need to clarify the status of cooperative housing under the Act. Immediate clarification will enable a beginning while we look at longer term solutions.

Miscellaneous. Finally, there is other clarification we believe reasonable. The Council recognizes the wisdom in the provisions in the Sasser-Baker legislation of clarifying first time homebuyer requirements and targeted area definitions. We support such clarification, particularly the specific exemptions in the first time homebuyer requirement for families previously occupying substandard housing, and for those replaced by governmental action. We also support recognition of the problems of energy impacted areas by the targeting techniques. The need for some other legislative clarification has been relieved by regulation, but legislation may still be preferable.

We have many other concerns which we have addressed to Treasury. These concerns were brought forth by regulation and we seek regulatory relief. If relief is not forthcoming by regulation however, some of the issues would become legislative priorities. We have attached a list of these problems. We hope you consider our position reasonable and that you direct Treasury to eliminate unnecessary regulations and to clarify and simplify other requirements.

Closing Remarks

The combination of last years Act and the regulations pertaining thereto have been catastrophic. We are seeking minimal changes to make the legislation workable. These changes will not impact on budget assumptions, in fact, the Joint Tax staff has found them to have no revenue impact. Indeed, we argue that a series of events have resulted or will result in tax expenditure decreases over the assumptions of the Treasury Department at the time of passage of the Act:

1. No bond issues to speak of in 1981
2. Reductions in the Section 8 Subsidy program mean a huge reduction in bond volume for multifamily housing.
3. Changes in tax law, particularly, the maximum tax being reduced to 50% from 70%, dramatically impact on all previous expenditure assumptions.

Housing is at its lowest production level since 1946. Relief from the most onerous provisions of low and regulation will help the industry without being inflationary. People will be re-employed, taxes will be generated, and the costs of other federal benefit programs will be reduced.

The proper statutory and regulatory changes would go a long way in repairing the damaged federal and state relationship over tax policy. We are not the enemy. We may have different needs and purposes, but to treat the relationship as adversarial is to do damage to our fundamental constitutional concept of a federal form of government. This year upwards of $200 billion in "all savers" tax exempt funds were legislated with only one basic requirement, 75% must be in housing investments. We would like you to bestow on us the same trust you bestowed upon private financial institutions issuing "all savers" funds. Thank you for the opportunity to testify. We urge you to act quickly.

CSHA YIELD ANALYSIS SUMMARY

Overview

During CSHA's discussions with the Treasury Department about the impact of the new law and the possibility of obtaining a workable set of regulations, there was heavy focus on yield and arbitrage analysis. The objective was not to develop the worse case scenario. Rather an attempt was made to test the boundaries of the new act to see if there was a way to make the numbers work for state housing agency programs. However, particular emphasis was placed on continued structuring which would allow an issuer to obtain a double A rating with the commensurate savings to the borrower of 1/4 to 1/2 percent. The following analysis conclusively establishes that the 1% yield limit is unworkable on a standard issue.

There are two distinct facets to the yield question. First, how much is needed to pay for the costs of the normal range of programs (ie. issues of varying size and somewhat varying structure)? Second, how may an issue be structured so that a double A rating may be obtained?

As to the first question, there are a number of costs which must be paid from the 1% yield allowed on the mortgage loans (all of which are stated on an annual yield basis).

1. Origination fee -.125%
2. Costs of underwriting and issuance - .28-.34% (varies based on size of issue)
3. Mortgage Servicing - 375%
4. Pool insurance - .05%
5. Trustee's and paying agent fees - .02%
6. Issuer's operating expenses - .10-.16%

TOTAL .95 - 1.06%

Thus, it can be seen that if all goes well, there are no increases in expenses, and there are no losses in excess of available investment earnings, an issuer should be able to break even.

However, there is a second facet which involves various chashflow scenarios. These chashflow tests are posed by the rating agencies and must be survived by a bond issue in order to obtain a particular rating. These tests are necessary because of a need to demonstrate "parity" to the bondholders. On any mortgage revenue bond issue, the proceeds of the issue are used to fund two different things. First, about 97.5% of an issue goes into mortgage loans. Since this money is being used to purchase a real asset, this portion of the issue is called the asset bond portion. The other 2.5% of the issue is used to pay for the fees and expenses involved in selling the bonds. Since no asset is being purchased, this portion of the bond issue is called the non-asset bond portion. Thus, in the event that all of the mortgage loans funded from a $100 million issue were to pay off within 1 year of origination, the issuer would be left with approximately $97.5 million in cash to pay off $100 million in bonds. With this background, a critical question for any bond issue is, given various origination and prepayment assumptions, at what point are the asset bonds in parity with the outstanding bonds. Below is a summary of the attached feasibility tests, which demonstrates the problems encountered in reaching parity.

Summary of Feasibility Tests

Finding (1) Our approach was sufficiently close to that used by the Joint Tax Committee that we could demonstrate how they came to the conclusion that 1% was feasible, and why we did not concur with that finding. Basically the 1% could be made to work if the service fee was reduced to .30 rather that .375 (a bizarre assumption given the fact that the complexity of this legislation probably doubles the time to be spent by the servicer in originating the loan), if the assumption was made that all administrative costs were to be absorbed by the issuing agency, and if the step down mortgage procedure developed by Joint Tax was utilized. This approach resulted in a marginal feasibility for larger issues (50 million or more) meeting bond rating tests sufficient to obtain an A rating. With sufficient volume ($100 million or more) the issue might qualify for a double A rating.

Finding (2) Assuming a 500% prepayment test, a standard servicing fee of .375, and $90,000 for administrative costs per year, we are unable to make the numbers feasible at 1% even at $100 million. Given the 6 month convention on prepayments (which is not permitted under the regulations), we were able to generate sufficient cash flow on a $100 million issue, with an undesirable 3 points from the borrower up front, to allow the 1% to work. The workability would be further enhanced by stepping down the mortgage rate by charging a higher interest rate for the first 3 years and reducing it thereafter. The advantage of this approach is that the higher cash flow up front helps build parity more quickly and after the parity test is met, the cash flow is like a snowball rolling downhill and accumulates quite rapidly.

Finding (3) Several methods suggested by the Joint Tax Committee were not found to be of use in obtaining greater feasibility at the 1% level. These included various bond call techniques, increased spread in the step down mortgage approach, and other miscellaneous suggestions.

Finding (4) Assuming that the 6 month convention for prepayments generates about 12 to 15 additional basis point, we came to the conclusion that a 1.25% yield, when used in conjuntion with the step down mortgage approach, would allow for a reasonably sized issue to be feasible at bond rating tests that were used in 1979 to qualify new issues for double A ratings. A yield of 1.25% allows payment of both an administrative fee to the agency and a standard industry fee for servicing. If the size of the reserves were reduced, and origination points increased feasibility would result. It should be noted, however, that any increase in origination points has a negative impact on borrower eligibility. Thus it may be possible to make smaller than $50 million issues work at 1.25%. There are two primary reasons for this phenomena. The first is that any monies collected in advance immediately build toward parity and are worth much more than funds collected at future dates. Second, the standard and traditional reserves used in these bond issues are now a negative drag on the yield because they must be invested at the bond interest rate, but the actual interest rate is higher due to the discount for the payment of underwriter or issuance costs. In effect these costs may only be recouped from the portion of the issue invested in mortgages. Thus, the reserves are a negative drag onthe cash flow.

Conclusion Structuring an issue in the historical manner will require a much greater allowable spread than 1%. Some would argue that up to 1.5% may be necessary for smaller issues. Restructuring issues may reduce the necessary increase in yield over the 1%, but our calculations indicate that reasonably sized issues need at least 1.25% to be economically self supporting and to obtain the requisite double A rating.

ECONOMIC FEASIBILITY ANALYSIS
of
SINGLE-FAMILY MORTGAGE REVENUE BOND PROGRAMS
under the
MORTGAGE SUBSIDY BOND TAX ACT of 1980

Prepared by:
Council of State Housing Agencies
March 10, 1981

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	Issue ($ million)	6-Month Convention Applied to:
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Tab E	25	Regular Payments
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SCOPE OF ANALYSIS

Analytical Approach

We performed cash flow analyses for each of three "prototype" issues of Single-Family Mortgage Revenue Bonds whose respective issue sizes were:

1) $100 million;
2) $50 million; and
3) $25 million.

On Page 177 of the Conference Report, it is noted that because the yield on the bonds ordinarily is computed on a semi-annual basis, the same semi-annual compounding interval should be used in the computation of the effective interest rate on the mortgages. Accordingly, receipts of monthly mortgage payments are to be treated as received on the next succeeding bond interest payment date. The semi-annual compounding and receipt methodology is consistent with that permitted under Treas. Reg. 1.103-13(c)(6) and permits the mortgages to bear a slightly higher interest rate than if effective interest rates were computed on the basis of monthly compounding.

When computing the mortgage effective interest rate in the manner described above, it is observed that the incremental increase in the mortgage interest rate is different depending upon whether mortgage prepayments are assumed to occur (i) monthly, or (ii) annually or semi-annually as a lump sum. Mortgage revenue bond programs have traditionally been structured and analyzed under an assumption of monthly scheduled payments and prepayments because (i) prepayments do, in fact, occur throughout each year, and (ii) the cash flow risk and reinvestment risk inherent in a particular issue can only be properly assessed by assuming that prepayments occur monthly rather than as a lump sum just prior to a bond interest payment date.

Due to the difference in the increment to mortgage yield referred to above, each of the three prototype bond issues was analyzed under both yield-spread alternatives. The first alternative follows the traditional practice of assuming that prepayments occur ratably during each month of the year, while the second alternative treats prepayments as if they occur in a lump sum, semi-annually, on the succeeding bond interest payment date.

A standard set of assumptions (outlined below) was used for each analysis. The only variable was the amount of the equity contribution required, if any, to sufficiently strengthen program cash flows to permit the timely redemption of all bonds and the payment of all budgeted operating costs under an assumed 500% mortgage prepayment rate. This criteria was applied as a measure of each issue's ability to receive an investment grade rating in the third highest rating category, or higher. Such ratings are deemed essential to produce sufficiently low mortgage rates to achieve the program's public purpose.

Assumptions Underlying Analyses

The following assumptions were consistently applied in each of the six separate analyses:

1) Mortgage terms

   * 30 years
   * Fees charged to mortgagors - 3% of mortgage principal
   * Purchased in equal quarterly installments, at par
   * Prepayment penalties - 2% of remaining mortgage principal for loans prepaying any time within their first 5 years of life
   * 30-day lag in availability of mortgage revenues to pay bond debt service
   * Prepayments at 100% of FHA rate for U.S. (GNMA method of calculation)

2) Mortgage Servicing - .375% per annum (payable monthly) on the outstanding principal amount of loans in portfolio (industry standard fee)

3) Mortgage Origination Fee - paid by the issuer from fees collected from mortgagors; 1% of the original principal balance of each loan

4) Pool Insurance/Special Hazard Insurance Premium - .05% per annum (payable monthly) on the outstanding principal amount of loans in portfolio

5) Bond Redemption

   * proportional (strip) call
   * redemption from revenues remaining after payment of scheduled debt service, trustee/paying agent fees, and all budgeted operating costs

6) Debt Service Reserve Fund

   * initially established at 11% of the issue (approximately equal to maximum future annual debt service on all bonds except those issued to fund the Debt Service Reserve Fund)
   * reduced in size to maintain the Fund at 11% of bonds outstanding

7) Mortgage Reserve Fund - none

8) Investment Rates

   * Mortgage Acquisition Fund - Bond Yield
   * Debt Service Reserve Fund - Bond Yield
   * Debt Service Fund (Float) - Bond Yield

9) Issuance Costs

   * Underwriters Discount - 2% (Note 1)
   * Fixed Cost of Issuance - $150,000
   * Capitalized Interest - approximately equal to one month's interest, at the Bond Yield, on the amount deposited in the Mortgage Acquisition Fund

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Note 1: Refer to Appendix TAB I for detail concerning the basis for the underwriters' discount assumed.

10) Program Operating Costs

- Trustee/Paying Agent
  - $10,000 annual fee
  - 12.5c per coupon paid
  - $1.00 per $5,000 bond redeemed
- Issuer's Operating Budget
  - $90,000 annually for $100 million program
  - $50,000 annually for $50 million program
  - $25,000 annually for $25 million program

11) Bond Coupon Scale

Year	Rate	Year	Rate
1983	7.500	1991	9.300
1984	7.750	1992	9.450
1985	8.000	1993	9.600
1986	8.250	1994	9.750
1987	8.500	1995	9.900
1988	8.750	1996	10.000
1989	9.000	1997-01	10.375
1990	9.150	2002-13	10.750

Summary Conclusions

The Table on the following page sets forth the key observations and conclusions regarding each of the six issues analyzed.

The data in this Table reveals that:

1) The only issue which continued to be economically viable under the 500% prepayment test without an equity contribution was Case A — a $100 million issue with prepayments calculated to occur monthly.

2) All other issues examined required an equity contribution ranging from a low of 0.5% of the issue size to a high of 1.5% of the issue size.

3) As one would intuitively expect, the required equity contribution increases as issue size decreases.

These observations and conclusions regarding the relative merits of each financing plan are a function of the difference between Bond Yield and Mortgage Yield, rather than the absolute levels of each. That is to say, actual bond interest rates could be substantially above or below the levels assumed in our analysis without affecting the validity of our basic conclusions.

SUMMARY TABLE OF RESULTS
Economic Feasibility Analysis
of
Single-Family Mortgage Revenue Bond Programs
under the
Mortgage Subsidy Bond Tax Act of 1980

		Bond Issue		Mortgage Portfolio Characteristics					Payments to Program Participants					
Case	6 Month Convention Applied to:	Bond Issue Size ($000)	Bond Yield* (%)	Principal Amount	Mortgage Rate (%)	Mortgagor Fees (%)	Prepayment Penalties (%, by year)	Mortgage Yield* (%)	Mortgage Orig. Fee (%)	Mortgage Svc. Fee (%)	Pool Ins. Premium (%)	Annual Operating Budget	Issuer Equity Payment ($000)	Cash Flow [illegible] Test
A	Regular Payments	100,000	10.536	87,857,140	11.25	3	2,2,2,2,2	11.528	1	.375	.05	90,000	None	Yes
B	Scheduled Payments	100,000	10.539	88,367,344	11.05	3	2,2,2,2,2	11.508	1	.375	.05	90,000	500	Yes
C	Regular Payments	50,000	10.535	44,107,140	11.25	3	2,2,2,2,2	11.528	1	.375	.05	50,000	250	Yes
D	Scheduled Payments	50,000	10.538	44,362,244	11.05	3	2,2,2,2,2	11.508	1	.375	.05	50,000	500	Yes
E	Regular Payments	25,000	10.535	22,104,588	11.25	3	2,2,2,2,2	11.528	1	.375	.05	25,000	250	Yes
F	Scheduled Payments	25,000	10.538	22,232,120	11.05	3	2,2,2,2,2	11.508	1	.375	.05	25,000	375	Yes

* Yield calculation in compliance with the Mortgage Subsidy Bond Tax Act.

ECONOMIC FEASIBILITY ANALYSIS
of
SINGLE-FAMILY MORTGAGE REVENUE BOND PROGRAMS
under the
MORTGAGE SUBSIDY BOND TAX ACT of 1980

Prepared by:
Council of State Housing Agencies
May 7, 1981

SCOPE OF ANALYSIS

This booklet contains the results of a series of cash flow analyses, all of which are variations of a $100 million Base Case. The Base Case is identical to the $100 million issue analyzed in Tab B of the CSHA Economic Feasibility Analysis prepared on March 10, 1981.

Base Case Assumptions

The following assumptions are incorporated in the Base Case cash flow analysis contained in Schedule I:

1) Mortgage Terms

    * 30 years
    * Fees charged to mortgagors - 3% of mortgage principal
    * Purchased in equal quarterly installments, at par
    * Prepayment penalties - 2% of remaining mortgage principal for loans prepaying any time within their first 5 years of life
    * 30-day lag in availability of mortgage revenues to pay bond debt service
    * Prepayments at 100% of FHA rate for U.S. (GNMA method of calculation)

2) Mortgage Servicing - .375% per annum (payable monthly) on the outstanding principal amount of loans in portfolio (industry standard fee)

3) Mortgage Origination Fee - paid by the issuer from fees collected from mortgagors; 1% of the original principal balance of each loan

4) Pool Insurance/Special Hazard Insurance Premium - .05% per annum (payable monthly) on the outstanding principal amount of loans in portfolio

5) Bond Redemption

    * proportional (strip) call
    * redemption from revenues remaining after payment of scheduled debt service, trustee/paying agent fees, and all budgeted operating costs

6) Debt Service Reserve Fund

    * initially established at 11% of the issue (approximately equal to maximum future annual debt service on all bonds except those issued to fund the Debt Service Reserve Fund)
    * reduced in size to maintain the Fund at 11% of bonds outstanding

7) Mortgage Reserve Fund - none

8) Investment Rates

- * Mortgage Acquisition Fund - Bond Yield
- * Debt Service Reserve Fund - Bond Yield
- * Debt Service Fund (Float) - Bond Yield

9) Issuance Costs

- * Underwriters Discount - 2%
- * Fixed Cost of Issuance - $150,000
- * Capitalized Interest - approximately equal to one month's interest, at the Bond Yield, on the amount deposited in the Mortgage Acquisition Fund

10) Program Operating Costs

- * Trustee/Paying Agent
    - $10,000 annual fee
    - 12.5¢ per coupon paid
    - $1.00 per $5,000 bond redeemed
- * Issuer's Operating Budget - $90,000

11) Bond Coupon Scale

Year	Rate	Year	Rate
1983	7.500	1991	9.300
1984	7.750	1992	9.450
1985	8.000	1993	9.600
1986	8.250	1994	9.750
1987	8.500	1995	9.900
1988	8.750	1996	10.000
1989	9.000	1997-01	10.375
1990	9.150	2002-13	10.750

Analytical Approach and Summary Conclusions

Schedule II contains cash flows for a $100 million issue identical to the Base Case, with the following exceptions:

1) the servicing fee was reduced from .375% to .30%;

2) the mortgagor fees were reduced from 3% to 2%;

3) the $90,000 operating budget was eliminated; and,

4) the $500,000 issuer equity contribution was eliminated.

The results of this analysis indicate that the maximum prepayment rate sustainable under these structuring assumptions is 450%.

Schedule III contains cash flows for a $100 million issue structured exactly the same as that analyzed in Schedule II, above, except that the bond redemption strategy was changed from a "proportional strip" call to a "long bond first" call in which the bonds with the longest maturity are called first. This strategy produces the lowest bond interest cost over the life of the issue (which, in turn, dictates a concurrent reduction in the mortgage rate), but also results in a default condition approximately midway through the program when revenues are no longer adequate to pay debt service on the remaining serial bonds. This analysis demonstrates the cash flow risk inherent in the "long bond first" call strategy and indicates why it is seldom used by issuers.

Schedule IV contains cash flows for a $100 million issue structured exactly the same as that analyzed in Schedule II, above, except that the bond redemption strategy was changed from a "proportional strip" to a "super sinker" or "short term bond first" call. Consistent with the change, the coupon on the short term bond was reduced from 10.375% to 10.00% to reflect the significantly shorter average life for these bonds which results from applying all excess revenues to call these bonds ahead of all other term bonds. The resultant slight reduction in Bond Yield necessitated a .05% reduction in the mortgage interest rate. Under these structuring assumptions, the maximum sustainable prepayment rate was only 300%. Accordingly, one of the primary tests of bond security was failed.

Schedule V contains cash flows for a $100 million issue structured exactly the same as that analyzed in Schedule II, above, except that a "stepdown" mortgage plan was used. This plan involves the financing of mortgages with an initial interest rate of 11.50%. The rate is subsequently reduced to 11.00% in the fourth year of the program so as to result in an Effective Mortgage Interest Rate (at a 100% FHA prepayment rate) which complies with the 100 basis point spread limit. This change produces more mortgage interest income in the early years to be applied to the redemption of bonds. As a result, the issue is able to pass the 500% prepayment test.

Schedule VI contains cash flows for a $100 million issue identical to the Base Case, with the following exceptions:

1) the mortgagor fees were reduced from 3% to 2%;

2) the $500,000 issues equity contribution was eliminated; and,

3) a "stepdown" mortgage plan was used.

An "industry standard" servicing fee of .375% was maintained, as was a very conservative operating budget allowance of $90,000 annually. The data in Schedule IV indicate very clearly that this financing plan produces an economically unfeasible issue. Specifically, program revenues under this scenario were inadequate to redeem bonds, even at a low 100% FHA prepayment rate.

ECONOMIC FEASIBILITY ANALYSIS
of
SINGLE-FAMILY MORTGAGE REVENUE BOND PROGRAMS
under the
MORTGAGE SUBSIDY BOND TAX ACT of 1980

Prepared by:
Council of State Housing Agencies
June 15, 1981

SCOPE OF ANALYSIS

This booklet contains the results of a series of cash-flow analyses, all of which are variations on a $100 million Base Case. The Base Case is identical to the $100 million issue in Schedule VI of the CSHA Economic Feasibility Analysis prepared May 7, 1981, although it has been changed slightly to reflect a recalculation, (to one which is operationally more efficient) of the mortgage amortization schedule. All cash flows enclosed reflect the addition of a reinvestment rate (at the Bond Yield) on the "ending cash balance carried forward", computed semi-annually.

Base Case Assumptions

The following assumptions are incorporated in the Base Case cash flow analysis contained in Schedule I:

1) Mortgage Terms

   * 30 years
   * Fees charged to mortgagors - 2% of mortgage principal
   * Purchased in equal quarterly installments, at par
   * Prepayment penalties - 2% of remaining mortgage principal for loans prepaying any time within their first 5 years of life
   * 30-day lag in availability of mortgage revenues to pay bond debt service
   * Prepayments calculated as a percent of experience for U.S. (GNMA method of calculation)

2) Mortgage Servicing - .375% per annum (payable monthly) on the outstanding principal amount of loans in portfolio (industry standard fee)

3) Mortgage Origination Fee - paid by the issuer from fees collected from mortgagors; 1% of the original principal balance of each loan

4) Pool Insurance/Special Hazard Insurance Premium - .05% per annum (payable monthly) on the outstanding principal amount of loans in portfolio

5) Bond Redemption

   * proportional (strip) call
   * redemption from revenues remaining after payment of scheduled service, trustee/paying agent fees, and all budgeted operating costs

6) Debt Service Reserve Fund

   * initially established at 11% of the issue (approximately equal to maximum future annual debt service on all bonds except those issued to fund the Debt Service Reserve Fund)
   * reduced in size to maintain the Fund at 11% of bonds outstanding

7) Mortgage Reserve Fund - none

8) Investment Rates

* Mortgage Acquisition Fund - Bond Yield
* Debt Service Reserve Fund - Bond Yield
* Debt Service Fund (Float) - Bond Yield
* Ending Cash Balance Carried Forward - Bond Yield

9) Issuance Costs

* Underwriters Discount - 2%
* Fixed Cost of Issuance - $150,000
* Capitalized Interest - $750,000 (approximately equal to one month's interest, at the Bond Yield, on the amount deposited in the Mortgage Acquisition Fund)

10) Program Operating Costs

* Trustee/Paying Agent
  $10,000 annual fee
  12.5¢ per coupon paid
  $1.00 per $5,000 bond redeemed

* Issuer's Operating Budget - $90,000

11) Bond Coupon Scale

Year	Rate	Year	Rate
1983	7.500	1991	9.300
1984	7.750	1992	9.450
1985	8.000	1993	9.600
1986	8.250	1994	9.750
1987	8.500	1995	9.900
1988	8.750	1996	10.000
1989	9.000	1997-01	10.375
1990	9.150	1001-12	10.750

SUMMARY OBSERVATIONS AND CONCLUSIONS

This series of cash-flows seeks to analyze the "stepdown" mortgage plan. A stepdown mortgage carries a higher initial rate than would otherwise meet the arbitrage restrictions (100 basis points over the Bond Yield), and subsequently drops in rate, or "steps down" to a lower rate. The effective date for the stepdown occurs in the fifth year of the program, and is determined so as to result in an Effective Mortgage Interest Rate no more than 100 basis points over the Bond Yield, at 100% FHA prepayment rate. The results of this analysis are summarized on the following page.

SUMMARY TABLE OF RESULTS: STEPDOWN MORTGAGE PLAN

CASE	OPERATING BUDGET ($)	ISSUER EQUITY ($)	STEPDOWN MORTGAGE PLAN CHANGE (%)	RATES (%)	TIMING	SPREAD COMPLIANCE BOND YIELD (%)	EFFECTIVE MORTGAGE RATE (%)	DIFFERENCE (%)	PASS SENSITIVITY TESTS 0%	100%	500%
Base	90,000/yr.	0	±.25	11.50/11.00	4 yrs., 6 mos.	10.54	11.53	.99	NO	NO	NO
I-A	90,000/yr.	0	±.50	11.75/10.75	4 yrs., 7 mos.	10.54	11.53	.99	NO	NO	NO
I-B	90,000/yr.	1,600,000	±.50	11.75/10.75	4 yrs., 7 mos.	10.56	11.53	.97	YES	(YES)	(YES)
I-C	0	1,000,000	±.50	11.75/10.75	4 yrs., 7 mos.	10.56	11.53	.97	YES	YES	YES
II-A	90,000/yr.	0	±.75	12.00/10.50	4 yrs., 7 mos.	10.54	11.53	.99	NO	NO	NO
II-B	90,000/yr.	2,900,000	±.75	12.00/10.50	4 yrs., 7 mos.	10.54	11.53	.99	YES	YES	YES
II-C	0	2,000,000	±.75	12.00/10.50	4 yrs., 7 mos.	10.55	11.53	.98	YES	YES	YES

October 12, 1981

Mr. John C. Chapoton
Assistant Secretary for Tax Policy
Department of Treasury
Washington, DC 20005

RE: Treasury Regulations
Under the Mortgage Subsidy
Bond Act of 1980

Dear Mr. Chapoton:

Thank you for the opportunity to have met with you on October 1st to discuss the impact of the Mortgage Subsidy Bond Act of 1980 ("1980 Act") and related Treasury regulations on the issuance of mortgage revenue bonds. The subject of mortgage revenue bonds has been (and will continue to be) before the President's Commission on Housing and its four reporting Committees with all its attendant controversy and complexity. In its October 30th Interim Report to the president the Commission will identify and discuss various mortgage revenue bond options and alternatives which will be considered in making the Commission's final housing policy recommendations to the President.

Incident to general discussion and testimony on mortgage revenue bonds, there has been focused and oftimes highly charged criticism of the 1980 Act, Treasury's single-family regulations, and Treasury's failure to issue multifamily regulations. From responsible state housing finance agency, bond underwriter, and bond counsel representatives has come a clear-cut consensus that the 1980 Act, as interpreted by Treasury's single family regulations, has had the effect of making bond issuances under these regulations infeasible and unworkable. Certain of these representatives point to Treasury's regulations as a "back door" method for effectively halting the issuance of single family mortgage revenue bonds. Other representatives attribute to Treasury's regulations a basic lack of understanding of the practical impact and impediments of various provisions of the regulations on the feasibility of bond issuances. Common to comments of these representatives is the view that Treasury's regulations have failed to provide a workable framework for issuance of single family mortgage revenue bonds and have thwarted the Congressional intent of the 1980 Act in permitting the issuance of "Qualified Mortgage Bonds". Moreover, there has been expressed speculation that similar problems will occur with the yet-to-be issued Treasury multifamily regulations.

Particularly in the case of the state housing finance agencies and the Council of State Housing Agencies ("CSHA"), which bring a public purpose perspective to the issue, are we sensitive to the criticisms of overly restrictive Treasury regulations. The state housing finance agencies were not the source of the abuses which bid to the 1980 Act, they supported the thrust of the 1980 Act in limiting the use of tax-exempt mortgage revenue bonds, and they prepared revisions to Treasury's regulations which are designed to assist in permitting issuance of bonds while carrying out the intent of the 1980 Act.

We enclose for your consideration an Addendum prepared by CSHA which cites provisions of the single family Treasury regulations, the practical issuance problems they have created, and CSHA's recommendations for changes in the regulations. We would request you to give particular consideration to CSHA's position with respect to the 95% requirement (part 1 of the Addendum) and allowable yield issues (part 2 of the Addendum). In the case of CSHA's position on regulation changes on the 95% requirement, we believe that CSHA's approach will permit unqualified bond opinions while maintaining compliance with and enforcement of the 95% requirement as expressed by Congress. In the case of allowable yield issues, this is a complex area which CSHA has analyzed in the context of Congressional intent. We believe that Treasury should consider CSHA's specific comments bearing on the overall issue of yield restrictions (e.g., more equitable treatment of prepayments of principal, removal of prepayment penalties from effective rate computations, permitting the taking into account of insured mortgage loan losses under limited circumstances, and the clarification of calculation of excess arbitrage).

To provide for a review of CSHA's position we are also forwarding the CSHA prepared Addendum to several national bond counsel for comment. On receipt, we will share these comments with you.

While we are well aware that the 1980 Act poses complex interpretive issues and that even the most liberal of Treasury regulations will not resolve all bond issuance problems presented by the 1980 Act, we believe that Treasury should take prompt and responsive conizance of legitimate and responsible recommendations for revising Treasury regulations to assist in issuance of mortgage revenue bonds within the limitations expressed by the 1980 Act and the intent of Congress.

Again, our thanks for the opportunity to have met with you and for the opportunity to have shared our individual views on this subject with Treasury.

Sincerely,

Stuart A. Davis

Stuart A. Davis, Commissioner
President's Commission on Housing

R K Helmbrecht

Richard K. Helmbrecht, Commissioner
President's Commission on Housing

G. Richard Dunnell, Commissioner
President's Commission on Housing

Robert V. Mathison

Robert V. Mathison, Commissioner
President's Commission on Housing

cc: Mayor Richard Carver
Shannon Fairbanks

COUNCIL OF STATE HOUSING AGENCIES

ADDENDUM

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1. THE 95% REQUIREMENT

The Regulations

There are three steps involved in implementing the 95% requirement in the Regulations. The first is the definition of qualified mortgage bond in Section 6a.103A-2(b)(1). The second is in the 95% requirement itself in Section 6a.103A-2(c)(1)(ii). The third step is the Regulations implementing the various mortgage eligibility requirements, which requirements are subject to the 95% requirement.

The Problem

The principal failures of the Regulations under paragraph (c) is that the Regulations do not provide issuer with sufficient clarification of the interplay between the 95% requirement and the requirements of paragraphs (d), (e), (f), and (j), and the ability of bond counsel to give an unqualified opinion is eliminated.

CSHA has no objection to the language of Section 6a.103A-2 (c)(1)(i). The language in Section 6a.103A-2 (c)(1)(ii) poses the most significant problems for issuers of bonds for homeowner financing. The Supplementary Information preceding the Regulations makes clear the extent to which the Department of the Treasury misjudged the impact of the Regulations when it states that "the 5% margin for nonqualifying mortgages protects the issuer from inadvertant error or mortgagor fraud." This statement is not correct. The mortgage eligibility requirements require an issuer to meet certain tests which require the determination of facts known only by the originating lender or servicer, in some cases, and to the borrower in most cases. The existence of a 5% margin for the bond holder is of little comfort when it is necessary to rely on the honesty of the borrower to protect the tax-exempt status of his investment. This is even a significant issue with home improvement loans because failure to use each and every dollar of the loan for qualified home improvements eliminates the exceptions provided in paragraphs (e) and (f) thereby raising the spector of non-compliance with the 95% requirement. The penalty of taxability of the bonds is much too great to justify the risk involved. This is particularly true when the individual mortgage eligibility requirements are difficult to comply with and are open to varied interpretations. In summary, the importance of an unqualified opinion cannot be stressed too much as it directly impacts on the marketability of the security and thus on the interest rate.

The CSHA Solution

The regulatory framework proposed by CSHA provides an approach which permits reliable compliance with and enforcement of the 95% requirement in a manner consistent with both the plain language of the Act and the intent of Congress. It would replace the unworkable requirements of the Regulations with a regulatory approach which does not place an unreasonable burden on state and local governments and the lending institutions with which they work to provide necessary financing for housing.

The proposed CSHA regulation for Sections 6a.103A-2(b)(1) and 6a.103A-2 (c), (d), (e), (f) and (j) would do the following:

(1) Establish a requirement in lieu of current Section 6a.103A-2(b)(1)(ii) which provides that the governmental unit shall have certified in the bond indenture or related document the requirements of Sections 6a.103A-1 and 2 shall be met. To the extent that this certification certifies future events, such certification may be based upon the reasonable expectations of the governmental unit on the

date of issuance. If, notwithstanding this certification, the requirements of Section s 6a.103A-1 and 2 are not met with respect to an issue, the Commissioner may disqualify by notifying the governmental unit. This disqualification will not effect bonds issued before the notice is published. Other provisions similar to those contained in current arbitrage Regulations could also be included.

(2) Establish for each mortgage eligibility requirement under Sections 6a.103A-2(d), (e), (f) and (j), a specified determination by the issuer, based upon affidavits from the mortgagor, and the seller of the residence, where applicable, as to specified facts. A determination by the issuer based on an affidavit should also be provided with respect to qualified home improvement loans. The intention to make such a determination based upon affidavits could be set forth in the govermental unit's certificate set forth in (1) above.

(3) Permit an issuer to exclude a nonqualifying mortgage from the computation of the 95% requirement where the issuer corrects or replaces it (eg. calls the loan, purchases or replaces the loan from non-bond proceeds, corrects the defect). The Regulations do not specifically address this question. The Act requires that "95% of the proceeds devoted to owner-financing was devoted to residences with respect to which (at the time the mortgages were executed) all such requirements were met." It is consistent with the Act that a correction or the replacement of the original principal amount of a non-qualifying mortgage with a qualifying mortgage or mortgages maintains the required purity of the use of the proceeds. In addition, an issuer should be permitted to call bonds with any funds obtained in correcting or replacing a mortgage.

Under paragraph (c)(1)(i) an issuer would still be required in good faith to attempt to meet all requirements before mortgages were executed. The issuer would still be required to include in the trust indenture, participation agreements with loan originators, and other relevant instruments restrictions that permit the financing of mortgages only in accordance with the relevant requirements. In addition, the issuer would still be required to establish reasonable procedures to insurance compliance with the requirements, including reasonable investigations by the issuer or its agent to determine that the mortgage has satisfied the requirements. The key change is that an issuer would be permitted to ascertain with respect to each loan that, for purposes of the 95% requirement, the loan qualifies on the date made. The requirements of subparagraph (iii) remain, that any failure to meet the requirements must be corrected within a reasonable period after such failure is discovered.

The revised mortgage eligibility requirements also give meaning to the 95% requirement in (c)(1)(ii). Where an issuer fails to meet the requirements of the revised paragraph (d), (e), (f) and (j) through error on its part, the loans will count against the 95% requirement.

2. ALLOWABLE YIELD ISSUES

2.a. PREPAYMENTS OF PRINCIPAL

The Regulation

Section 6a.103A-2(i)(2)(ii)(E) specifies that where interest on an issue is paid semiannually (as in the case of most bond issues) all regular monthly payments may be treated as being received at the end of each semiannual debt service period. However, prepayments of principal must be treated as being received as of the last day of the month in which they are received.

The Problem

There is no reason for a distinction between prepayments and regular amortization payments of mortgage loans, in deciding whether six months of expected payments should be aggregated to the next bond interest payment date. The point of aggregation is simply to facilitate a comparison between bond payments and cash available to pay them. This provision has a significant negative impact on the financial feasibility of qualified mortgage issues.

The question of aggregation arises in the context of a required prepayment assumption which is adopted only as a convention, and at best a very rough approximation, to make possible the computation of a composite mortgage interest rate and bond yield. In any given case the actual effective mortgage rate in retrospect will be more or less than an estimate based on 100% of FHA history, and this deviation may well be much greater than the difference occasioned by aggregation. Prohibiting aggregation of prepayments simply multiplies the expense of computer time in valuing a stream of 360 payments after 30 years instead of 60.

The CSHA Solution

Amend the regulation to provide that if interest on an issue is paid semiannually, all regular monthly mortgage payments and prepayments may be treated as being received at the end of each semiannual interest period.

2.b. CALCULATION OF EFFECTIVE RATE OF INTEREST

The Regulations

The Regulations, in Section 6a.103A-2(i)(2)(ii)(A), define the "effective rate of interest" on the mortgage loans for the purpose of the calculation of the permissable 1% spread between the yield on the bonds and the effective rate of interest on the mortgages. The regulation includes a list of the types of payments paid by the mortgagor in connection with the loan which must be taken into account in computing the effective rate of interest. The list includes items such as points, commitment fees, etc. Prepayment penalties are included among the listed items.

The Problem

Prepayment penalties should not be included in the computation of the effective rate of interest. Such penalities are not mentioned in section (i)(2)(B)(i) or (ii) of the law. They are not payable as a condition for obtaining the mortgage or as a cost of servicing it, like all of the other amounts mentioned. They are not payable at all unless the mortgage is prepaid, which is a decision made by the mortgagor and not the mortgagee.

The fact that under Section 6a.103A-(2)(iv) of the Regulations prepayments must be assumed to follow FHA statistics in determining the effective mortgage interest rate, is irrelevant to the decision whether prepayment penalties should be included in determining the rate. Whatever assumption is made as to prepayment will certainly not be correct. The purpose of a prepayment penalty is to make prepayment possible without loss of income necessary to pay bonds issued for expenses of making the mortgage loans.

There would be no purpose in permitting a 1% spread between the effective mortgage interest rate and the bond yield, if it were not intended to cover the payment of those bonds issued in excess of the amount of the mortgage loans, to pay necessary initial expenses of issuing the bonds or making the mortgage loans which are not included in determining either the mortgage interest rate or the bond yield; i.e. underwriter's spread, cost of bond issuance and mortgage points and fees. The mortgage loan amortization has to exceed the bond amortization by enough not only to pay the servicing charges, trustees' fees and other future expenses that drop off as loans and bonds are paid, but also to amortize bonds issued for initial expenses.

The term of the loan necessary to amortize initial expense may be ascertainable, and is likely to be quite long because the permitted spread is so narrow. The entire spread on any loan prepaid before this time is lost, including the part needed to pay for these initial expenses. The function of a prepayment penalty is to recover the borrower's share of the principal amount of bonds issued for the initial costs which is unamortized at the time of prepayments. To attempt to calculate this item into the computation of the effective mortgage interest rate is to introduce a guess into an equation which must work if the bonds are to be paid.

The obvious purpose of the law is to save money for those who need the lowest mortgage loan interest rate that can be obtained; not for those who no longer need it. Including the cost of prepayment in the cost of borrowing to provide this low interest rate is likely either to make such borrowing impossible, or to increase the borrowing cost, and consequently the mortgage interest rate, to a much higher level because of the risk factor.

The CSHA Solution

Delete prepayment penalties from Section 6a.103A-2(i)(2)(ii)(A) of the Regulations.

2.c. POOL INSURANCE

The Regulations

Section 6a.103A-2(i)(2)(v) prohibits an issuer of bonds from taking into account any portion of the losses on its mortgage pool covered by pool insurance.

The Problem

While it is agreed that the full cost of pool insurance premiums should not be automatically allowed as an exclusion from yield, the artificial and unfair result that an issuer who expects (based on past experience) .05% in incidental losses not covered by primary insurance may take into account such expected loss in computing yield, while the issuer who procures pool insurance for .08%, both for the prupose of obtaining a higher bond rating (and lower interest cost to the borrower) and providing for reimbursement of incidental losses is prohibited from making any adjustment to yield. Deduction of pool insurance premiums should be allowed to the extent these premiums do not exceed the net losses which would have been projected had pool insurance not been obtained. This provision would not be inconsistent with legislative history. In addition, the borrower would still be benefited by the use of pool insurance since the premium is much less than the reduction in interest rate obtained through the use of pool insurance.

The CSHA Solution

Amend Section 6a.103A-2(i)(2)(v) to permit an issuer to project net losses in any year without respect to pool insurance, except that where pool insurance is involved, the projected net losses in any year may not exceed the pool insurance premium for that year.

2.d. CALCULATION OF ARBITRAGE AND INVESTMENT GAINS

The Regulations

Section 6a.103A-2(i)(4)(i)(A) provides that in computing the amount of excess arbitrage the amount of any gain or loss realized on the disposition of the investments is to be taken into account. However, Section 6a.103A-2(i)(4)(ii) provides for an annual computation period.

The Problem

It is unclear from the regulation whether undistributed funds accumulated from previous amount computation periods may be used to offset negative arbitrage or investment losses incurred during a current annual computation period. It is clear from the legislative history that Congress intended to allow such a set off. Congress specifically stated that these funds may be accumulted by the issuer until a mortgage loan is fully repaid. (p.177 of the Omnibus Reconciliation Act of 1980). The purpose of this provision was to allow a sufficient financial cushion to protect against negative arbitrage.

The CSHA Solution

The Regulations should provide at Section 6a.103A-2(i)(4)(ii) that any undisturbed moneys available for rebate to mortgagors or the United States may be used to offset arbitrage losses (including losses realized on the disposition of nonmortgage investments).

3. REDUCTION OF NON-MORTGAGE INVESTMENTS

The Regulations

Section 6a.103A-2(1)(3)(i)(B) requires that the amount invested in nonmortgage investment be promptly and appropriately reduced as mortgages are repaid.

The Problem

Under this provision, an issuer could be required to sell securities at a loss, even though there is no past arbitrage and investment gains available to offset such a loss. Thus the issuer would have no means, other than independent funds, with which to offset this loss.

The CSHA Solution

Section 6a.103A-2(1)(3)(i) should provide that it is not appropriate to reduce the aggregate amount invested in nonmortgage investments if the reduction may only be made at a loss.

4. REFUNDING OF EXISTING MORTGAGE SUBSIDY BONDS

The Regulations

The Act and the Regulations clearly prohibit the advance refunding of Mortgage Subsidy Bonds, as provided in Sections 103A(n) and 1104(j) of the Act. The intention of Congress to prohibit such an advance refunding is clear from the discussion in the House Budget Reconciliation report at P.469 and the Conference Report at P.178. Neither the Act nor the Regulations address the refunding which is not an advance refunding (that is one within the period of 180 days prior to the date on which the prior issue is discharged) of bonds issued for owner-financing of housing prior to the effective date of the Act.

The Problem

Issuers of bonds must have the ability to refund bonds when the payment of principal becomes due. The use of refunding bonds will most frequently occur when the stream of payments securing an issue varies significantly from expected payments so that the issuer is unable to make the payments of principal when due. This will most likely occur when there is a differenence of expected and actual prepayments. The refunding bonds are not used directly or indirectly for owner-financing but are used to refund an existing debt. There is no evidence in the Act or the Legislative history that Congress intended to prohibit the refunding of obligations as permitted by the proposed language.

The CSHA Solution

Amend Section 6a.103A-1(a)(4) to make it clear that only advance refunding is prohibited, and that refunding bonds (issued on a date less than 180 days before the date on which the prior issue is discharged may be issued before or after December 31, 1983.

5. HOME IMPROVEMENT LOANS

5.a. QUALIFIED HOME IMPROVEMENT LOANS - SECOND MORTGAGES

The Regulations

The Regulations at 6a.103A-2(j)(1) provide that "all of the lendable proceeds must be used to provide mortgage loans to persons who did not have a mortgage (whether or not paid off) on the residence securing the mortgage note at any time prior to the execution of the mortgage".

The Problem

The Act and Regulations clearly contemplates the use of qualified mortgage bonds for qualified home improvement loans. In almost every case of a home improvement loan, there will be a pre-existing first mortgage on the property.

The CSHA Solution

Amend Section 6a.103A-2(j)(1) to except qualified home improvement loans from the prohibition against prior mortgages.

5.b. HOME IMPROVEMENT LOANS - TOTAL LOAN AMOUNT

The Regulations

The Regulations place a limit of $15,000 on the total principal amount of qualified home improvement loans.

The Problem

This is another instance where it would be more rational to base the Regulation upon the approach used in the FHA Title I Regulations. Under FHA Title I, the limit on insured loans is based upon the outstanding principal amount of the loans. This regulation will create unnecessary confusion for the lending institutions which originate home improvement loans. A Title I lender must determine the outstanding principal amount of existing loans in processing a normal FHA Title I application. It would be much less burdensome for the lender to use the same process for qualified Home Improvement Loans.

The CSHA Solution

Amend Section 6a.103A-2(b)(9)(iii) to place a limit of $15,000 on the total oustanding principal amount of qualified home improvement loans.

5.c. HOME IMPROVEMENT LOANS - ELIGIBLE IMPROVEMENTS

The Regulations

The Regulations define the term qualified home improvement loan, which describes the type of loan which can be made or purchased under the Act.

The Problem

The language of the Regulation defining eligible improvements imposes an unnecessary regulatory burden on the issuer of tax-exempt bonds to be used to finance qualified Home Improvement Loans. The regulation primarily relies on the Housing Budget Reconciliation Report at p. 452 for the language used in this subparagraph. The regulation both narrows the range of eligible improvements and lack sufficient clarity to provide guidance to an issuer.

The CSHA Solution

It would be much less burdensome to base the regulation upon the Budget Reconciliation Conference Report at p. 172 where it is stated that "the conferees intend that the guidelines used for determining eligibility for insurance under Title I are to be used on an interim basis in determining what items qualify for home improvement loans until Regulations are promulgated. "The Regulations should make the Title I guidelines the basis of the definition".

The reason is simple. Most existing home improvement loan programs operated with tax-exempt financing are based upon the FHA Title I program. They are efficient programs since lenders with previous experience with the Title I guidelines do not have to train their staff to participate in the program. Moreover, because of the small principal amount of these loans, the origination fees paid to the lenders are minimal. There is no way to increase the origination fees sufficiently to justify the training needed for a new set of guidelines.

In addition, this unnecessary variation from an existing Federal program contributes to the image of Government as an institution which creates needless duplication of complex program requirements when simple solutions are available.

6. MISCELLANEOUS PRIORITY COMMENTS

6.a. AREAS OF CHRONIC ECONOMIC DISTRESS

The Regulations

The Regulations include a provision for withdrawal by the State of the designation of an area as an area of chronic economic distress. The provision permits withdrawal "with reasonable cause." In addition, the Regulations place a limit on the percentage of the total population in a state which can fall within areas of chronic economic distress.

The Problem

The withdrawal of designation of areas of chronic economic distress is a matter properly left to the states. The Federal interest in designation of areas of chronic economic distress is adequately addressed by the control over designation of these areas in the first instance. If an area is withdrawn from designation, no new area can be designated without Federal approval.

Similarly, the proper function of the Federal departments under the Act is to review designation of areas of chronic economic distress according to the criteria set forth in the Act. It is the function of the states to select these areas. If more than 20% of the state is, by objective criteria, within areas of chronic economic distress, they should be so treated upon designation by the state and approval by the Federal departments.

The CSHA Solution

Both of these provisions should be deleted. If the language requiring "reasonable cause" is not deleted, there should be language added to provide that the undesignation is effective 10 days after submission to HUD unless the state is otherwise notified by the Secretary. If the Regulation is not amended to remove the 20% limitation it is important to revise the regulation to make it clear that the 20% requirement applies to the population with areas at the time of HUD approval and that designation continues until withdrawn or amended.

6.b. *THE DEFINITION OF LENDABLE PROCEEDS*

The Regulations

The term "lendable proceeds" refers to the portion of the bond proceeds which must be devoted to owner-financing. (Section 6a.103A-2(b)(I)(i)).

The Problem

The definition in the regulation does not include reference to "capitalized interest" and "accrued interest" as an amount to be subtracted from the bond proceeds to obtain the lendable proceeds. Most bond issues include capitalized interest and accrued interest in the principal amount of the bonds. It is essential that the Regulations clarify that the amount of the capitalized interest and accrued interest be subtracted from the proceeds before arriving at the lendable proceeds since the capitalized interest is not available for owner-financing.

The CSHA Solution

Amend Section 6a.103A-2(b)(1)(i) to permit "capitalized interest" and "accrued interest" to be excluded from the lendable proceeds.

6.c. REIMBURSEMENT ALLOWABLE IF YIELD LESS THAN 1%

The Regulations

Section 6a.103A-2(i)(4)(iv) provides for a reduction in the amounts to be paid or credited to mortgagors where the issuer does not use the full 1% spread. This is likely to occur where there is an issuer contribution.

The Problem

The Act establishes in Section 103A(i)(8) that all determinations of yield are to be made on an actuarial basis taking tinto account the present value of money. For no apparent reason, this concept was not followed in the case of recouping any unused portion of the 1% spread, this unfairly penalizes the issuer who takes a spread of less than 1%.

The CSHA Solution

Amend Section 6a.103A-29i)(4)(iv) to permit credit amount provided to be compounded forward at a rate equal to the bond yield plus 1%.

6.d. ISSUER CONTRIBUTIONS FOR MORTGAGOR COSTS

The Regulations

The fourth sentence of Section 6a.103A-2(i)(2)(ii)(D) of the Regulations states that the interest rate, fees and other amounts charged with respect to the portion of a mortgage loan financed with non-bond amounts may not exceed reasonable and customary amounts charged where financing is not provided through a qualified mortgage bond issue.

The Problem

There is no basis for this regulation in the Act, which speaks only of whether particular charges can be included in determining effective mortgage interest rates. The fifth and sixth sentences, following on this misstatement, imply that the issuer cannot, without affecting the effective rate, subsidize the mortgagors by itself paying charges which, while they may be more than or different from charges when financing is not provided through a qualified mortgage issue, nevertheless have to be paid in order to make it possible to sell such an issue, or to sell it at a rate low enough to permit a reasonable mortgage interest rate.

State governments are often willing to undertake a limited obligation in the form of a front end subsidy, sized in relation to their resources at the time, which may persuade the market to buy revenue bonds at a rate low enough to do some good.

The CSHA Solution

Amend Section 6a.103A-2(i)(2)(ii)(D) to provide that points, origination fees, servicing fees and other charges paid from non-bond amounts shall not be deemed paid by the mortgagor or financed from bond proceeds.

6.e. CALCULATION OF THE STATE CEILING

The Regulations

The Regulations provide a formula for the State's determination of the 9% ceiling. The formula lists the types of owner financing which may be included in the determination.

The Problem

The Regulation does not permit a State to count land contracts. It has been estimated that in 1981 land contracts will consititute approximately $30 billion in financing, which will exceed the 1980 lending levels of the nation's savings and loan institutions. To exclude such a major portion of owner-financing from the ceiling amounts is unreasonable and arbitrary.

The CSHA Solution

Amend Section 6a.103A-2(g)(6)(i) to permit the State to include land contracts.

6.f. PRINCIPAL RESIDENCE REQUIREMENT

The Regulations

The requirement of the Act that owner-financing be provided for principal residences is expanded upon in Section 6a.103A-2(d).

The Problem

In addition to the problem addressed in the "95% Requirement" issue, there are three problems with the principal residence provision:

1. The Regulation makes ineligible for a loan a residence where any portion of the residence is used in a trade or business. This goes beyond the Act which, in the House Committee Report suggests that the definition of principal residence under Section 1024 of the Code be used. This is unnecessary overregulation of issuers. Whatever small abuse this requirement may prevent is not worth the effort required to enforce this requirement. This is because there are too many gray areas in the application of this requirement. Where does one draw the line relating to use for day care, tupperware parties, newspaper routes, etc. Given the purchase price limits and the requirement that there be intent to use as a principal residence, this requirement is regulatory overkill.

2. There needs to be a date certain upon which the determination regarding factory made housing in (d)(4) is considered conclusive.

3. Paragraph (d)(4)(ii) introduces a tremendous amount of unnecessary complexity on the issue of how much land may be included. This requirement introduces a tremendous number of factual cases where the correct answer is not clear. For instance, would this provision be met where a home sits on a 1/2 acre lot with frontage of 150 feet in a subdivision of essentially similar lots where the law requires a minimum lot width of 40 fet and total size of one tenth of an acre. Again, given the purchase price limits and the general ban on prior home ownership, this requirement is regulatory overkill.

The CSHA Solution

1. The trade or business language should be eliminated. If the Department wishes to include some form of reference to this type of use in the regulation, it should provide that any portion of a residence used for the specified purposes is not principal residence. This is consistent with the treatment of a principal residence under Section 1-34 of the Code.

2. The determination regarding attached housing should be conclusive as of the date when made by the issuer.

3. The Paragraph (d)(4)(ii) should be deleted.

6.g. RECYCLING OF PREPAYMENTS

The Regulation

The Regulations in Section 6a.103A-2(i)(2)(vi) define the "yield on the issue" for the purpose of the arbitrage calculations. This is done based upon the issue price and an expected maturity for the bonds consistent with the prepayment assumption required in Section 6a.103A-2(i)(2)(iv).

The Problem

The bond yield must be fixed once for all on the date of delivery, if the required comparisons with the effective interest rates on the mortgage are to be meaningful. Also, the "expected maturity for the bonds", based on a prepayment assumption is sure to be wrong, and any error will jeopardize the security of the bonds. Finally, there appears to be no reason to limit recycling of mortgages more than once.

The CSHA Solution

Amend the last sentence of Section 6a.103A-2(i)(2)(vi)(A) as follows: "The preceding sentence shall not apply to prepayments of mortgages provided from original proceeds to the extent that such prepayments are expected to be used to provide mortgages. The actual maturities of the bonds need not be fixed in accordance with the expected maturity upon which the yield on the issue is determined, if sufficient amounts of the bonds are permitted and required to be called for redemption within the period allowed in subparagraph (3)(ii)(A) to exhaust any amount of such prepayments which are not used within that period to acquire additional mortgages."

6.h. TEMPORARY PERIODS

The Regulations

The Regulations in Section 6a.103A-2(i)(3)(ii) provide temporary periods for the investment of proceeds in mortgages of 1 year (1½years for target areas) and 13 months for a bona fide debt service fund.

The Problem

It is not apparent why the maximum initial temporary period for unlimited investment of original proceeds or prepayments, until "needed for mortgages", as contemplated in Section 103A (i)(3)(B) of the act, should be less than the maximum temporary period of 3 years, provided in Section 1.103-14(b)(1) and (11) of the Regulations for original proceeds or for acquired obligation payments held in a revolving fund, until "needed for the purposes for which such issue was issued" as contemplated in Section 103 (c)(4)(A). Single family housing programs operated by State Housing Finance Agencies, in effect, make loans by or through lenders located throughout the states in which they operate. These lenders vary greatly in their sophistication. Given the complexity of the mortgage eligibility requirements under 103A of the Act, it is unrealistic to expect that all loans for new construction will be processed from commitment through disbursement by the HFA within one year. Several HFA's are attempting to use bond funds to finance end loans for newly constructed attached units with design competition to produce energy efficient units at locations where urban services are currently available. It is impossible to operate this type of program, with local government cooperation and a design selection process within a one year time frame.

In addition, it is not apparent why the recycling of prepayments into new mortgages should be restricted to those prepayments originally designated for such use.

In Section 6a.103A-2(i)(3)(ii)(B), the temporary period only applies to "repayments of principal and interest on mortgages." Repayments of principal and interest on mortgages are not the only amounts needed for a bona fide debt service fund. A debt service fund also aggregates non-mortgage investment earnings up to the aggregate amount which would have been earned if all investments were invested at a rate equal to the bond yield. A 1% mortgage bond yield spread will never cover debt service on a borrowed reserve in addition to all the other expenses which are excluded from the yield comparison.

The CSHA Solution

Section 6a.103A-2(i)(3)(ii)(A) should be amended to use the same 3 year temporary period provided in Section 1.103-14(b)(1) and (11). The reference to designated prepayments should be changed to prepayments desired to be used to acquire additional mortgages.

Section 6a.103A-2(i)(3)(ii)(B) should be amended to apply to "Proceeds (other than excess earnings and income attributable thereto under subparagraph (4)(i))" contributed to a bonafide debt service fund.

6.i. CALCULATION OF ISSUE PRICE

The Regulation

Pursuant to Section 6a.103A-2(i)(2)(vi)(B), the issue price is the price at which a substantial amount of the obligations were sold to the public.

The Problem

The implication of the above requirement is that the issue price can only be determined after a substantial amount of the obligation have been placed with public buyers. This often will not occur prior to the delivery date of the bonds.

The CSHA Solution

An amendment should be made to the Regulations making clear that all calculations of yield should be made as of the date of issuance of the bonds and should be based on the issuer's reasonable expectations as of the date of issuance.

Senator PACKWOOD. Next we will move on to a panel of James Holmes, Paul Brophy, William Morris, and John Arbib. Gentlemen, go right ahead. We will start off with Mr. Holmes.

STATEMENT OF JAMES HOLMES, PARTNER, HOLMES & GRAVEN, MINNEAPOLIS, MINN.

Mr. HOLMES. Mr. Chairman, Senator Durenberger, my name is Jim Holmes. I am a partner in the Minneapolis law firm of Holmes & Graven. I also, over the past year, have had the opportunity to serve on one of Senator Durenberger's committees considering housing need and housing production questions in the State of Minnesota.

I would like to apologize. My testimony did not arrive on time last night and we had some problems with delivery today. I believe you now have it before you, but I am sure you haven't had a chance to go through it. I would like to just summarize some of the high points in it if I could. And I would like to say that my views are from the perspective of local issuers as opposed to State issuers, or at least from the perspective of issuers involved in housing bond issues of a size that is considerably smaller than you typically see in a single-family issue by State housing finance agencies.

The reason for that is that we represent many municipalities and redevelopment agencies throughout Minnesota. More importantly, we think there are some distinctions to be made and some policy considerations that should be given to those distinctions.

There has been a lot of talk about the question of local contribution to these kinds of programs, and just what that might involve and whether that was intended or not intended. I think I could give you an example of one of the few bond issues that have been closed since the Tax Act, the only one I believe in Minnesota. It was a qualified home improvement loan issue, really a housing energy rehabilitation program in the city of Minneapolis. Bonds in the amount of $2,750,000—a very small issue—were placed with 12 private institutions in the city of Minneapolis. The purchases were negotiated by the staff of the Minneapolis Community Development Agency, so that there was no underwriter and no underwriting discount involved in the transaction.

The Minnesota Gas Co., a natural gas utility in our State, agreed to originate the loans and to service the loans at no cost either to the borrower or the issuer. They did so primarily because the Minnesota Public Utilities Commission had ordered utilities in Minnesota to participate in pilot energy conservation programs.

Bond proceeds were drawn down from the various lenders at the time of purchase of the individual loans by the agency from the utility companies, and the repayments from the borrowers were passed directly through the utility to the lenders. Therefore, there was no investment earning on nonmortgage investments. The issuer—in this case, the Minneapolis Community Development Agency—paid all costs of issuance, estimated to be approximately $65,000, and will be only partially repaid from the 1-percent spread between the effective interest rate on the loans and the yield on the bonds.

In addition, the agency posted $200,000 in cash that it had available to a debt service reserve. The gas utility contributed $50,000 to the debt service reserve; and an additional $300,000 to individual loan prepayments.

I give you that example, I hope, not for the purpose of convincing you that, in fact, local issuers can generate funds to make these programs work, but to give you an idea of the proportion of the contribution, at least in this case, that had to be made, and we feel would generally have to be made in an issue of this size, to make it workable.

The other point I would just like to touch on is that I agree with most everything that has been said about the 95-percent rule. It is horrendous. It has to be modified. It has to be a forward-looking rule. It just isn't going to work to constantly look backward over your shoulder to see whether or not you have more than 5 percent bad loans. I would like to emphasize, however, the 1 percent arbitrage spread problem. And I would like to support something that Senator Durenberger said by way of a question. That is that you at least consider the idea of some kind of a sliding scale—perhaps between 1¼ and 1½ percent. We have seen calculations, and I don't have them with me—I will see that they are provided to you—that based on a certain set of assumptions in a given bond issue of $100 million, and then reduced to $20 million, that the necessary spread in order to recover the cost of issuance goes from something like 1.16 to 1.4 something. And I will get you those figures. It is a function of size. And I think that local issuers may be much more concerned about having additional flexibility in the permissible arbitrage spread. So we would hope that you would at least take a look at the concept of a sliding scale.

We also feel strongly about the multifamily provisions in Senator Durenberger's bill with respect to the period of time that the 20-percent subsidy commitment has to be made. In the State of Minnesota, we are looking at various local subsidy techniques, or at least trying to find one that can be substituted for a lack of section 8 funds. One of the things we are looking at in that State to provide a subsidy is tax increment financing from the housing facility itself. A 20-year commitment to pay that subsidy presents as many and perhaps more questions to local policymakers than it does to Congress and HUD, who, as you know, has been concerned for some time about the term of that subsidy. So we certainly support the provisions in your bill with respect to term.

Again, thank you for your time and permitting us to appear here today.

Senator PACKWOOD. Thank you, Jim.

[The prepared statement follows:]

TESTIMONY OF JAMES S. HOLMES, HOLMES & GRAVEN, MINNEAPOLIS, MINN.

Mr. Chairman, Members of the Committee. I am Jim Holmes—a partner in the Minneapolis law firm of Holmes & Graven. Also, I have had the privilege of serving as chairman of a Senator Durenberger Task Force which has been studying the question of housing needs and housing production in Minnesota.

I appreciate the opportunity to appear before you today and to speak in favor of S. 1656, relating to housing mortgage revenue bonds. My testimony today will be from the perspective of local government. There are two reasons for this. First, our firm serves as issues's counsel or bond counsel to many Minnesota cities and housing and redevelopment authorities, so that tends to be our orientation. More importantly, we believe there exists some significant differences between state and municipal housing issues, or at least between large issues, which tend to be by state housing finance agencies and smaller issues, which tend to be by local municipalities.

There are three parts of S. 1656 which I would like to address: the 95 percent compliance test and the 1 percent arbitrage yield spread which relate to owner-occupied housing and the 20 percent subsidy requirement for multifamily rental housing. As an introduction to my comments in these areas, let me say that I, and the local officials with whom I have talked, support the goals of targeting loans made with tax exempt bond proceeds to distressed areas, to first time home buyers and to modest cost housing units. I also believe there is general support for limitations on the total volume of these bonds, since local officials worry about the impact of volume on their ability to carry out more traditional kinds of financing. These goals are reasonable and should control the issuance of housing revenue bonds. The purpose of my testimony is not to try to undo the policy decisions that were made by Congress in 1980. Unfortunately, however, the 1980 Act and the proposed regulations make it very difficult, if not impossible, for most cities and housing authorities to implement programs which would in fact accomplish the goals of the 1980 Act. It is important that you understand that it hasn't been just a difficult bond market that has resulted in a dearth of housing issues since the enactment of the 1980 Tax Act.

We believe that Congress intended that local issuers be able to implement housing revenue bond programs, so long as they accomplished the objectives of the Tax Act. Yet today these bonds can be issued only under very limited, special circumstances. For example, our firm was recently involved in the first local housing revenue bond issue in Minnesota under the Act. Let me relate the unusual facts surrounding that issue which we believe made it possible. The program to be financed with $2,750,000 of bonds is a residential energy rehabilitation program in the City of Minneapolis. The bonds were placed with twelve private lenders and these purchases were negotiated by the staff of the Community Development Agency so that no underwriter was required. The Minnesota Gas Company, a local natural gas utility, is originating and servicing the loans at no charge to the borrower or the issuer, essentially because it was ordered to do so by our Public Utilities Commission in order to assist in energy conservation. Bond proceeds are drawn down from the bond buyers as needed to purchase the loans from the utility, and repayments by the borrowers are passed through directly from the utility to the bondholders as received. Therefore, there are no investment earnings on nonmortgage investments. The issuer is paying all costs of issuance, estimated to be $65,000, and will be partially repaid from the one percent spread between the effective interest rate on the loans (11 percent) and the yield on the bonds (10 percent). A debt service reserve of $250,000 was funded with non-bond proceeds of the issuer ($200,000) and the utility ($50,000). Even this reserve would not have been adequate to satisfy the lenders, but since non-bond proceeds are not subject to the new arbitrage provisions, the reserve could be increased through investment income to 15 percent of the issue, or $412,500. In addition, the utility contributed $300,000 to the program for the purpose of prepaying up to 10 percent or $100 of each energy loan, so that the estimated average life of the loans could be reduced to a level satisfactory to the lenders. The utility, as originator of the loans, would not assume responsibility for absolute compliance with the 95 percent requirement, since noncompliance could be the result of borrower fraud. Therefore, prior to purchase the issuer must review each mortgage loan, each borrower and each building in order to verify compliance. This review, of course, requires staff and dramatically increases to issuer's costs.

In summary, this energy rehabilitation program, designed to conserve residential energy resources, worked because:

(1) There were no origination, servicing or trustee's fees;

(2) There were no underwriter's fees;

(3) The issuer had funds on hand to pay costs of issuance, even if not fully reimbursed, so there were no so-called "nonasset" bonds;

(4) The issuer had an additional $200,000 on hand to fund a debt service reserve;

(5) The issuer had the staff and funding to verify compliance with the 95 percent test;

(6) The Minnesota Public Utilities Commission ordered the pubic utilities in the state to participate in pilot energy rehabilitation programs; and

(7) The utility contributed $50,000 in cash to a debt service reserve and $300,000 to borrowers for the purpose of prepaying loans.

This situation is obviously unique. I suspect that not many local issuers have this much going for them.

This leads me to the major point of my testimony—what we believe must be done to enable local government to issue housing revenue bonds to financed owner-occupied housing under the Tax Act. While all of the provisions of S. 1656 are important, two deserve special attention.

First, the requirement that 95 percent of the lendable proceeds must be in loans which comply with the Act's requirements regarding first time home buyers, purchase price, residency, and refinancing—without regard to why this may not occur—must be modified. It is simply too much to expect a loan originator to assume absolute liability for mortgage loans which are found, after the fact, not to meet the limitations, especially when that liability includes the possibility of interest on the bonds being taxable. It is impossible for an originator to know with absolute certainty that all of the limitations are met. Yet issuers, faced with this standard must either ask for these assurances or undertake its own verification. This dilemma can be resolved by providing, as S. 1656 does, that only loans which are not corrected and for which diligent efforts are not made to correct them count against the 5 percent "bad loan" limitation.

Second, the one percent arbitrage limitation must be increased. Here I differ slightly with S. 1656 and I suspect you will hear disagreement between large issuers with existing cash flows and small issuers with none. For many cities who would issue housing revenue bonds in smaller amounts of 10, 20, or 30 million dollars, and who do not have funds available from previous housing programs, the 1¼ percent ceiling is not adequate. Because of other arbitrage restrictions in the Tax Act, they will still not be able to issue. The interest spread necessary to successfully implement a program is inversely proportional to the size of the bond issue and the availability of other funds. We have seen calculations which show that a 100 million dollar bond issue, structured to meet rating agency requirements, permitting no recovery of administrative costs by the issuer and allowing for prepayment penalties needs a spread of approximately 1.16 percent in order to cover $150,000 of fixed costs and an underwriting discount of 2.35 percent. If the issue size is decreased to 20 million dollars, which would be the upper limit for most local issuers in Minnesota the spread needs to be 1.4 percent in order to recover the same $150,000 of fixed costs of issuance and an underwriting discount of 2.35 percent. If the issuer cannot pay for all of its administrative costs, or if state law does not allow prepayment penalties (as is the case in Minnesota), then the necessary spread could increase to 1.55 percent or more. We also must assume that originators will be willing to participate in a program with fees comparable to those in past issues, even though the Tax Act may require additional verification activities.

Briefly, before I conclude, I would like to touch on the amendment to Section 103(b)(4) relating to industrial revenue bonds issued for multifamily rental housing. The requirement that 20 percent of the units of a project financed with tax exempt bonds be set aside for low income individuals is a good one. However, as Congress considers reduction of the Section 8 program, the primary source of the 20 percent subsidy must be local government. In Minnesota, many issuers are looking to the use of tax increment financing to provide this subsidy through the use of increased real estate taxes generated by the housing facility. The current law which requires that the subsidy be provided for 20 years or the term of the bonds, whichever is greater, unfortunately is exceedingly restrictive. Congress has considered the financial problems created by authorizing Section 8 contracts for 20 years or longer, and I believe this has been at least partially responsible for the controversy over the

Section 8 program. If tax increment is used in Minnesota to provide the subsidy, (1) it would be desirable to get the property back on the tax rolls before 20 years has elapsed and (2) it is difficult to project the exact subsidy needed over 20 years so it is difficult to insure that the tax increment will be adequate to fund the subsidy for the entire period.

We strongly support the amendment contained in S. 1656 which we think strikes a reasonable balance between the difficulties of providing long term rental subsidies and the need to provide housing which is affordable by low income people.

Once again, Mr. Chairman and Members of the Committee, thank you for the opportunity to appear before you today.

You may be wondering why so much emphasis is being placed on one-fourth to one-half percent of one percent interest earnings. Prior to the passage of the Tax Act, in addition to being able to set the mortgage rate at up to 1½ percent above the rate on the bonds, issuers were able to earn unlimited investment earnings on reserve funds which could equal up to 15 percent of the amount of the bond issue and on certain other funds held for temporary periods. From these earnings issuers were able to pay the costs of the program and to meet rating agency tests. With the application of the new 1 percent limitation on all investment earnings a substantial source of revenue has been eliminated. Because of the impact of these changes, local issuers are concerned that the modifications proposed in S. 1656 be adequate to meet their needs. Therefore, if you believe that there is value in having cities and housing authorities able to issue housing revenue bonds at the local level, where there is substantial ability to identify local needs, then the yield differential must be increased—and we think increased beyond that suggested in S. 1656.

We would propose that you consider adopting a sliding scale from 1¼ percent up to 1½ percent based upon issue size and that this be included in S. 1656.

SUMMARY OF STATEMENT

(1) Most local government units have been unable to issue bonds for owner-occupied housing under the permanent rules of the Mortgage Subsidy Bond Tax Act of 1980.

(2) The differential between the effective interest rate on mortgage loans and the yield on housing bonds necessary to make a single family housing mortgage program work depends upon the size of the bond issue and the amount of funds which the issuer has to contribute to the issue.

(3) The changes proposed in S. 1656 will help enable local governments to issue bonds for housing programs.

(4) The arbitrage yield differential of 1 percent—which is increased to 1¼ percent by S. 1656—should be amended to include a sliding scale with 1¼ percent for larger issues and 1½ percent for smaller issues.

(5) The changes proposed in S. 1656 with respect to the 20 percent requirement for low income housing will facilitate the construction of multifamily rental housing.

STATEMENT OF PAUL BROPHY, DIRECTOR OF THE PITTSBURGH DEPARTMENT OF HOUSING

Mr. **Brophy**. Good morning, Senator. I thank you for this opportunity to testify, and I thank you for the leadership you have shown in putting this hearing together.

I am here this morning representing the National Association of Housing and Redevelopment Officials. NAHRO is a group that, for the past 47 years, has been representing individuals and public agencies involved in housing and community development. In addition to my being an active member, NAHRO has asked me to testify because the city of Pittsburgh is one of the few cities in the country that has floated bonds that have met the provisions of the 1980 act. In August of this year, the city of Pittsburgh, through its urban redevelopment authority, floated an $11 million issue for qualified home improvement loans. Therefore, I can speak firsthand to the difficulty of meeting all of the requirements that the Federal law imposes.

The NAHRO position on the 1980 bill was and continues to be, that some regulation is indeed needed in the area of mortgage revenue bonds; that the unconstrained use of these proceeds was not in the Nation's public interest. NAHRO supported changes that would both target these loans to low and moderate income persons and target the loans to areas within the city that are in need of rehabilitation and restoration. The law, as it currently stands, despite Pittsburgh's ability to meet these requirements, is a terrible law in that it puts an end to, rather than controlling, the issuance of tax-exempt financing, with very little exception. Fortunately, Pittsburgh was able to be one of those exceptions.

You have heard this morning from other speakers on the issue of arbitrage. I, too, would urge that either bill be passed so that the arbitrage restriction is above 1 percent. We had to put into our $11 million issue about $1,600,000 of local resources, both to make our numbers work and to provide some subsidy to low- and moderate-income persons below the rate that we would have gotten on the bonds and the home improvement loans themselves. Fortunately, this is the fourth time we have floated these bonds, and we had reserve funds from earlier bond issues that we could bring to the table to make this work or we would not have been able to do it. Given a city like Pittsburgh that is confronting cutbacks in our community development block grant program, which we have used for this purpose in the past, we are in a very difficult position in trying to meet this arbitrage restriction and at the same time face curtailments in our community development block grant funds which have been used for this kind of purpose in the past.

The 95-percent test for good faith compliance was without a doubt the toughest nut we had to crack. Think of what this provision does; it says that we are not going to be wrong 5 percent of the time for the next 30 years. It was not easy convincing our lawyers that we could run a program that tightly. And we were able to do that, I think, in part, because of a good track record.

We currently have about 4,000 loans outstanding. Of those 4,000 loans, only one have we been able to discover was a bad loan in terms of the new law. Someone went out and bought a car with our money instead of making repairs to his house. Under the provisions of our program, the bank had to buy that home improvement loan back. But under the law, that one would count against the 5 percent. What that has meant to us is that we have had to change our programs so that instead of inspecting one out of every three houses to see that they were complying with the law and to see that the work was being done, we now have to inspect every house. We have had to make our building inspectors notary publics, so they can take sworn affidavits from individuals saying that they indeed live in their property. We now have to cross-reference files from one telephone book to the next, very arduous work on our part, none of which is, in our opinion, making the program any better, but is simply meeting these requirements. I urge that these requirements be changed. Additionally, our lawyers and financial consultants tell us that registration would cost at least 50 basis points, despite what the Treasury Department said this morning.

I agree with your philosophy, Senator, that we should not bring new program changes in at this point, but there are two or three minor points that I would urge. First, the first-time home buyer restriction we would like to see broadened, as has been done in

Senator Sasser's bill, to include homeowners who are displaced by public action or by natural disaster or who are currently living in substandard housing. And the multifamily housing requirements need to be changed, as they would be in Senator Durenberger's bill, to make the rehabilitation of small, multifamily buildings more feasible. They are not feasible under the current law. And, lastly, some technical limits on rehab; specifically, change $15,000 per property requirements to allow it to conform to the FHA title I loan program. And one point that has been missed in previous testimony, that I would like to make if I can take the time, Senator, the rehab component under the existing bill is looked at as though it needs to meet the test of the existing housing. That is, a rehab loan must be 90 percent of the existing housing requirements, which, in Pittsburgh, is about $50,000. It seems much more reasonable to me to group rehab with new construction since there is actually physical investment going on in the property. I urge that it be 90 percent of the new construction limit rather than the existing housing limit.

We have many neighborhoods in Pittsburgh that need rehab, but the cost of purchasing rehab is simply above the 90 percent figure on the used housing, but would be feasible if that limit were up against the new construction standard. I think that is a much more appropriate place to put rehab, in new construction, than in existing housing.

The written testimony goes on to point out that there is some clarification necessary to cover cooperative housing, and I would urge that that be considered as well.

In the interest of time, Senator, I would just again thank you and be ready to take your questions.

Senator PACKWOOD. Thank you very much.

[The prepared statement follows:]

NAHRO
Serving the Nation's Housing and
Community Development Needs

STATMENT OF

PAUL BROPHY

On Behalf Of

THE NATIONAL ASSOCIATION OF HOUSING AND REDEVELOPMENT OFFICIALS

on

S1348 and S1656

Before

Subcommittee on Taxation and Debt Management
United States Senate
October 16, 1981

National Association of Housing and Redevelopment Officials
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HIGHLIGHTS--NAHRO TESTIMONY ON S1348 AND S1656

NAHRO supports the following changes to the Mortgage Subsidy Bond Act of 1980:

Single-Family Housing

- increasing the arbitrage level from the current 1% cap
- provisions in S1348 and S1656 that change the 95% test for good faith compliance if mortgagees conduct audits and make efforts to correct violations
- elimination of the registration requirement contained in both S1348 and S1656
- provision in S1348 which expands eligibility to include inhabitants of substandard housing and those who have been displaced from their residence by natural disaster or governmental action.

Multi-Family Housing

- provision in S1656 which places income limits for Section 103(b)(4) purposes at 80% of area median income
- Senator Durenberger's provision which changes the 20-year low-income set-aside to the later of 10 years, one-half of the term of the obligation or the termination date of companion Section 8 assistance
- eliminating the 15-20% Section 8 occupancy requirement for projects under 50 units.

Rehabilitation-Technical Amendments

- tieing the home improvement loan dollar limits to FHA Title I loan limits
- that the purchase price limitations for the combined acquisition and rehabilitation of a property be based upon new construction prices in the area rather than on the purchase price of unrehabilitated existing properties.
- allowing "out-of-portfolio" purchase programs, under which proceeds are secured by mortgages held by lending institutions
- clarification of the multi-family provisions to explicitly include cooperative housing as an eligible activity under the law.

Mr. Chairman and members of the Subcommittee, I am Paul Brophy, Director of the Pittsburgh Department of Housing. I am here today representing the National Association of Housing and Redevelopment Officials. For 47 years NAHRO has been the professional association representing local housing and community development officials committed to the revitalization of our communities and neighborhoods, and to meeting the housing needs of all our citizens, particularly those with low and moderate incomes. NAHRO currently represents over 5,000 individuals and 2,100 public agencies involved in housing and community development programs.

We would like to share with you our concerns over the effects that the Mortgage Subsidy Bond Tax Act of 1980 has had on housing and community development programs and speak specifically to provisions of Senate bills S1348 and S1656, that seek to correct some of the deficiencies of the original legislation.

In 1979, NAHRO testified before the Congress in support of limiting tax-exempt mortgage bonds and targeting them in conjunction with comprehensive local strategies aimed at meeting local housing needs and/or neighborhood and community improvement goals. It is in this light that we appear today as representing housing and community development professionals. We realize the intent of Congress was not to stop the total issuance of bonds, rather to target the proceeds from bonds to those segments of our society that are in need of assistance in the provision of decent, safe and sanitary housing. However, since enactment of the law, many technical problems have arisen with certain provisions that have in fact precluded many communities from issuing tax-exempt obligations for housing and community development purposes.

Major provisions which inhibit the issuance of tax-exempt housing bonds include the rigid arbitrage restrictions; the 95% test for good faith compliance; registration; first-time homebuyer restrictions; and the requirement for 15-20% Section 8 eligible tenants in multi-family projects.

These provisions are rendering many types of projects unworkable. There are also certain technical provisions that are inhibiting the financing of rehabilitation and cooperative projects, and are creating, in our opinion, unintended restraints.

Mr. Chairman and members, as you may know, the city of Pittsburgh has issued one of the few tax-exempt housing obligations under the provisions of the new law. Because of the restraints of this legislation, we felt the only practical course was to limit our issue to single-family home improvement loans only, since this activity is exempt from some of the requirements associated with single family mortgages and multi-family projects. Even with this limited focus we encountered cumbersome hurdles in putting together an acceptable program. At this time, I would like to expand upon the above mentioned technical areas.

Arbitrage

As you are well aware, the 1980 Act restricts the arbitrage to 1%, a reduction from 1½%. This restriction has been an extremely difficult burden for issuing agencies, particularly since previously non-included costs such as origination fees and underwriters' discounts now must be included in the 1% spread. The new definition of arbitrage combined with the spread reduction from 1½% to 1% has prevented local agencies from structuring bond issues that can be financially self-supporting. While there may be agencies that believe the 1% limitation is workable, the cash flows do not allow most issuing agencies to have sufficient revenue to operate the program as well as receive a high bond rating. In Pittsburgh, the only way we could accommodate the arbitrage restrictions was by providing an infusion of funds available from the reserves provided by previous issues. This resource is not available to all communities, and will not be provided under any new issues due to the limitation on reserve funds under the new law.

Both S1348 and S1656 increase the arbitrage from the existing 1% to a higher set percentage rate. While we believe that the 1¼% provided in Senator Durenberger's bill would be adequate in most instances, we fear that it may be too restrictive for smaller communities with smaller bond issues. Since the cost of issuing obligations does not vary proportionately with the size of the issue, the 1¼% spread would not be sufficient in these latter instances. We believe attention should be given to providing higher arbitrage levels based upon the size of the issue.

95% Test for Good Faith Compliance

The 95% test of good faith compliance has proven to be the single most inhibiting factor in the issuance of single family mortgage subsidy bonds. The law imposes an unrealistic responsibility on issuing agencies to insure that 95% of the loans are in compliance with all provisions of the law. Lack of compliance through no fault of the issuer or investor, such as fraudulent statements on the part of the borrower, could result in loss of tax-exempt status. The burden is particularly onerous when applied to loan assumptions over the 30-year life of the bonds. Theoretically, 10, 15 or 20 years out, the loan assumptions could fail to meet the 95% test and the bonds could become taxable. Even if an error is found and immediately corrected that error still counts as part of the 5% allowance factor. If the 95% compliance factor is not met, the bonds become taxable retroactively from the date of issuance, not from the date when the 95% test is not met. This lack of certainty on the continued tax-exempt status of the bonds has made it virtually impossible for bond counsels to issue a clean opinion. A conditional opinion can put a bond issue at a disadvantage vis-a-vis other bonds on the market, and puts bond purchasers at tremendous risk. The provisions in both S1348 and S1656 would alleviate this problem by allowing mortgagees to correct violations when discovered. This much-needed change would remove the tremendous risk contained in the current legislation.

Registration

With one minor exception, no other tax-exempt bonds are required to be registered; the law clearly treats mortgage revenue bonds in a discriminatory fashion. Either all tax-exempt bonds should be required to be registered or none of them should. This requirement simply adds further administrative costs and burdens, hampering housing programs designed to reach lower income families. Since registration is generally alien to the tax-exempt market, this requirement detracts from the marketability of mortgage revenue bonds vis-a-vis other tax-exempt bonds. NAHRO supports the elimination of the registration requirement as contained in both Senator Sasser's and Senator Durenberger's bills.

First-Time Homebuyer

Prior to 1980, no restriction existed that related to the type of borrower who would be eligible to use tax-exempt funds to purchase a home. However, the requirement in the law that only first-time homebuyers could use tax-exempt funds to purchase a home has three implicit assumptions: (1) current homeowners have adequate equity to apply toward a new home; (2) current homeowners have a sufficient income to support the cash flow required with a new home mortgage; and (3) all homeowners currently reside in standard quality housing or better. These assumptions are not necessarily valid in all instances. NAHRO supports the provision in S1348 which expands eligibility to include inhabitants of substandard housing and those who have been displaced from their residence by natural disaster or governmental action.

Multi-Family Housing

Mr. Chairman, at this time I would like to focus on an area of the law which inhibits the issuance of bonds for multi-family housing. The law currently requires that 20% of all units (15% in targeted areas) in projects financed by tax-exempt bonds be occupied by Section 8 eligible persons for a period of at least 20 years. Since that provision was put into law, we have seen changes in Section 8 income definitions and the serious erosion of available Section 8 units, thus rendering this provision ever more difficult.

The language in the Act relies upon a Section 8 program low/moderate income definition of 80% or less of the area median income. However, the Omnibus Reconciliation Act of 1981 provides that no more than 10% of dwelling units which are available for occupancy under the Section 8 or public housing program before October 1, 1981, and which are leased on or after that date may be leased to tenants whose income is between 50 and 80% of the area median and 5% of those units that become available after October 1, 1981, can be leased to individuals with incomes between 50 and 80% of area median. The Conference Report did state that this limitation was not intended to affect the conditions established for project eligibility under Sections 103(b)(4)(A) or 167(K) of the Internal Revenue Code of 1954. NAHRO supports the language in S1656 which places income limits for Section 103(b)(4) purposes at 80% of area median income, thereby carrying out the understanding of Congress when it passed the 1980 Act, and eliminating any potential ambiguity created by the Omnibus Reconciliation Act of 1981.

Beyond the definitional problem, there is a financial problem in supporting projects with 15% to 20% low-income units for 20 years. First, this provision effectively excludes use of the Section 8 moderate rehabilitation program, which has a contract term of 15 years. Secondly, with the limited availability of Section 8 assistance of any type, project sponsors are going to have serious financial difficulty supporting a large percentage of low cost units and still maintain an overall moderate rental structure. For larger projects, this added cost could be mitigated if the term of the requirement was reduced. Senator Durenberger's bill addresses this issue by setting the term at the later of 10 years, one-half the term of the obligation, or the termination date of companion Section 8 assistance. NAHRO supports this amendment and believes that it will help to stimulate critically needed multi-family housing activity.

However, in the case of smaller projects, particularly small rehabilitation projects, the occupancy requirement is entirely unworkable.

Many cities have been attempting to expand their local rehabilitation programs. Particular attention has been given to supporting small rental properties, since these often comprise the majority of all units in need of rehabilitation. In Pittsburgh, for example, 75% of all rental units are in 1-10 unit buildings. Projects such as these have not been able to utilize the Section 8 programs because the administrative and processing burdens cannot be supported by such small projects. Recognizing this, cities such as Wichita, Portland (Oregon), Los Angeles, Alleghany County (Pennsylvania) and Pittsburgh have been operating simple, successful tax-exempt loan programs for small rental properties. The 15% to 20% low-income requirement would render these small projects financially unfeasible. In order to continue these critical revitalization programs, NAHRO urges amending the law to exempt rehabilitation projects under 50 units from the 15-20% low-income requirement.

Rehabilitation-Technical Amendments

The dollar limits for home improvement loans have been established in the 1980 Act at the level of $15,000 per property. We recommend that the limits instead be tied to the FHA Title I loan limits ($15,000 for one-family and $7,500 per unit for larger properties). This change would facilitate the rehabilitation of two, three and four-unit buildings. It would also tie the limits to a flexible rate, which is adjusted according to prevailing economic conditions, rather than setting a constant dollar amount in the law. Further, it would encourage program rules and requirements modeled after the FHA Title I program--a program with which lenders are familiar--rather than providing justification for a totally new set of definitions and criteria.

Secondly, NAHRO urges that the purchase price limitations for the combined acquisition and rehabilitation of a property be based upon new construction prices in the area rather than upon the purchase price of unrehabilitated existing properties. Economically, the cost of acquiring and rehabilitating a structure more closely parallels the cost of new construction than the cost of existing housing.

Thirdly, NAHRO recommends that cities and states be allowed to use "out-of-portfolio" purchase programs. Under such programs, bond proceeds are secured by mortgages held by lending institutions. However, the law provides that bond proceeds cannot be used to replace existing mortgages. We believe that this provision was not intended to prohibit the out-of portfolio financing technique. We would suggest that the language be clarified to correct this technical difficulty.

On the issue of refinancing, although the law specifically permits refinancing in the case of qualified rehabilitation of owner-occupied properties, recent IRS rulings limit refinancing for rental properties to no more than 10% of a bond issue. In our experience, refinancing is often necessary to make rental rehabilitation economically feasible and to keep rents at a moderate level. NAHRO recommends that the Act be modified to clarify that the same rules on refinancing should apply to the rehabilitation of rental properties as apply to owner occupied properties.

Cooperative Housing

As more and more families are being priced out of the individual homeownership market, cooperative arrangements are becoming an ever-increasingly viable and popular way to provide housing. Yet the law is not clear as to whether or not cooperative mortgages would qualify under the multi-family provisions of the law.

We urge clarification of the multi-family provisions to explicitly include cooperative mortgages to be treated as equivalent to mortgages on multi-family rental properties.

Mr. Chairman, NAHRO would like to commend you on holding this hearing on the Mortgage Subsidy Bond Act, and to commend Senators Sasser, Durenberger and their co-sponsors for introducing legislation to correct some of the deficiencies of that Act. It is extremely important that the technical problems that have beset the mortgage bond market this year be reviewed and redressed. It is timely, in light of the current budget cuts in the assisted housing field, that the deficiencies in the law be ironed out so that local housing and rehabilitation programs can once again place units for low and moderate income tenants on the market.

I would like to emphasize to the Subcommittee that tax-exempt mortgage bonds offer cities like Pittsburgh an opportunity to design innovative housing programs that meet their individual needs, and to supplement their existing low-moderate income housing and community development efforts. In line with the new era of federal deregulation and increased local autonomy, the ability to use mortgage bonds allows local public agencies to continue assisting those segments of our society that cannot afford housing on the private market.

I appreciate the opportunity to appear before the Subcommittee this morning, and would be happy to respond to questions. Thank you.

STATEMENT OF JOHN ARBIB, PAST PRESIDENT, FLORIDA STATE HOMEBUILDERS

Mr. Arbib. Thank you, Senator, for the opportunity of being here. You have a copy of my full written statement, and this statement that I will make today is not a written prepared statement, so I will cover those things that I feel to be the most important and also respond to some of the things that have been said a little earlier today.

I come to you as a representative of the National Association of Homebuilders of which I am a vice president, and also as a vice chairman of the Florida State Housing Finance Agency. This was a new agency that was created by a constitutional amendment last October, a year ago, and has been in business ever since, and has been trying ever since to issue bonds and to do the function for which the voters of the State of Florida created us; and that was to provide housing for low- and moderate-income people.

The Treasury Department, when it issued its rules for single families in July, said that the rules were reasonable, and that $15 billion worth of mortgage money for single family homes should be used between then and the end of the year. Senator, I submit to you that $14,950 million is still unexpended, and between now and December 31 will probably remain unexpended. So, obviously, between the legislation and the rules that were passed, we are not going to get the funds out.

Let me address one point that somewhat bothers me. The Treasury said that no extension of the sunset provision should be made. But the fact of the matter is that in basing the 9-percent limitations on the average of the previous 3 year's mortgage activity, we are actually going counterproductive to the things that we should be doing. As we go into next year and the year following, and perhaps the year following, hopefully, the limitations are going to be coming down because the mortgage activity in the housing industry in fact has been going down. So we have already lost the best potential year that we may have had for helping housing for low and moderate income people during this year. I would urge that among the things that you do, you do consider an extension of 3 years from whatever the effective date is of whatever the rules or changes are made that make the laws operative.

Florida—and I am only speaking of Florida because I can illustrate it, having personal knowledge of it—does not have any reserves. It has not sold any bonds. Very specifically in the legislation that created the agency, we were told we had to generate whatever funds we had to operate with, so we are in absolutely no position to subsidize in any way the 1 percent spread that is presently required and, therefore, we are literally out of business on single family.

I doubt whether it was the intent of the full Congress, as Mr. Chapoton seemed to indicate, to require that each agency participate financially in the issuance of these bonds. Certainly, Congress did not intend that some States would be totally out of the program simply because they had not been in the program previously.

I was pleased to hear Mr. Chapoton's response with regard to the good faith 95-percent requirement, but I am quite concerned that we first see the safe harbor figures before we accept that on its face value. For example, the safe harbor numbers that were issued under the regulations—and I speak as one experienced with the Fort Lauderdale/Hollywood SMSA, because I am familiar with that area where they say the average price of a new home was $69,500 in 1980. That is at least $10,000 from the actual mark. And what has happened in those and other figures was that, in fact, the Treasury Department included in its estimate of single family home prices multifamily condominiums for retirees, averaged together with single family detached, as one category which brought down the averages. Thus, I am concerned that the safe harbor numbers that they have given us are not, in fact, correct. As a matter of fact, for the State of Florida we figure that the total amount should have been 900 million, and we were told that the safe harbor number was 614 million. We don't know where that number came from and we don't know how we would generate more reliable information which Treasury says we must have in order to change the numbers that they have issued.

The big problem is—it has not been emphasized, although it was mentioned in the first testimony—housing is in a terrible state, not only for the homebuilder, where bankruptcies abound, and the suppliers, and whatnot, but for the home buyers. NAHB has this slogan: "Where will our children live?" It was never more true than it is today and will be tomorrow. And I think we must address these things. I think either bill would be acceptable, either S. 1348 or S. 1646. Probably 1646 (because it has less provisions than the other one) would be the way to go. We do hope that Congress will correct the problems that have been created in the original legislation. Thank you.

Senator DURENBERGER. Thank you very much.

[The prepared statement follows:]

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STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
before the
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE
on
MORTGAGE REVENUE BONDS
OCTOBER 16, 1981

Mr. Chairman and Members of the Committee:

My name is John Arbib and I am a homebuilder from Pembroke Pines, Florida. I am also Vice-Chairman of the Florida Housing Finance Agency and Immediate Past President of the Florida Home Builders Association. I am testifying today on behalf of the more than 123,000 members of the National Association of Home Builders (NAHB). NAHB is the trade association of our nation's homebuilding industry. Accompanying me today are Robert D Bannister, Senior Staff Vice President for Governmental Affairs and Jim Schuyler, Staff Vice President and Legislative Counsel for Governmental Affairs.

Mr. Chairman, first I would like to commend you for your leadership in moving expeditiously on the issue of mortgage revenue bonds. We are also appreciate the efforts of Senator Durenberger, Senator Roth, Senator Chafee, Senator Bradley and Senator Heinz who working together have developed a reasonable basis for discussion of the issues to be resolved regarding revenue bonds.

Since 1970, mortgage revenue bonds have provided one of the greatest opportunities for affordable housing for moderate and lower income families. Because revenue bonds have provided mortgages at below market interest rates, they have been particularly helpful to young families purchasing their first homes.

As you are well aware, the pendency of the so-called "Ullman bill" in 1979 and 1980 placed a de facto moratorium on the issuance of bonds by states and localities. In December, 1980, that impasse was finally resolved through the passage of the Omnibus Reconciliation Act, which provided for the future issuance of mortage bonds under certain limitations. The Act provided for the continuation of single-family bond programs with an annual volume cap by state, purchase price limit, first-time homebuyer requirement and expiration of the program at the end of 1983. Multifamily bonds could be issued if 20% of the units were made available for low income families.

We strongly believe that Congress and certainly this Committee intended that a workable program be implemented by the Treasury Department as expeditiously as possible. But this Committee is aware of the reality:

- It was not until July 1, 1981, almost seven months after the enactment of the bill, that the Treasury Department issued regulations for the single family program. This was after considerable pressure was placed on Treasury and the White House by members of Congress including members of this Committee and interested housing groups.

- Today, we are still awaiting the regulations for the multi-family program.
- Despite the considerable controversy generated by the single-family regulations, Treasury hearings were not scheduled until November 5, more than two months after the deadline for comments (August 31).
- On July 31, 1981, Assistant Secretary of the Treasury Roger Mehle showing recognition of problems raised with the regulations, stated to the President's Housing Commission that "the Treasury believes the regulations are reasonable and expects MSB volume to be in the range of $10-$15 billion annually..."

Mr. Chairman, the complexity of the statutory requirements coupled with the narrow and questionable interpretations of Treasury has meant that, other than bonds that were specifically exempted by the 1980 legislation, to date less than $45 million of bonds have been sold.

SINGLE-FAMILY HOUSING OUTLOOK

To understand the need for immediate legislative action in this area, it is important to note why mortgage revenue bonds are so critical to our industry and to the potential homebuyer at this time.

Mr. Chairman, housing activity has come to a virtual standstill across the country in the face of persistent high interest rates. Our nation's homebuilders are fighting for survival against mounting odds, and potential homebuyers are fighting a losing battle against mounting monthly mortgage payments.

Mr. Chairman, the industry whose mission is to provide housing for the American people is virtually out of business.

- New housing production for August was at a seasonally adjusted annual rate of 937,000 -- the lowest monthly rate since February 1975.
- Our projections indicate that housing production for 1981 may end up at only 1.07 million units -- the lowest year since 1946. Unless interest rates decline sharply, 1982 production levels will not improve very much.
- What about jobs? According to government statistics, 828,000 wage and salary workers in construction are unemployed. Add to this figure about 200,000 more who are self-employed.
- The unemployment rate of 16.3% (more than double the overall rate of unemployment) will likely increase to 19% by the end of the year -- and go higher in early 1982.
- A mere 2% of builders report that sales are "good to excellent." That compares with 70% to 80% in a good year.
- Traffic at subdivisions is almost non-existent -- fewer than 7% of builders report traffic to be "good to excellent." That compares with 40% to 50% in a good year.
- Failure rate among construction firms is up 41% for the period January to August 1981 as compared to the same period in 1980. Failure rate among subcontractors is up by 127%.
- Mortgage money generally is not available, and what is being offered is at record rates. Freddie Mac yields are over 19% in early October.

The ability to own a home is still a fundamental part of the American dream and a continuing aspiration for almost all our people.

But what is today's reality? Unfortunately, the numbers on affordability tell the sad story simply but graphically.

A modest $60,000 mortgage loan at 9% interest - the going rate two years ago - required a monthly payment of $483. At 16 1/2%, the payment is $831 per month, almost double the payment of two years ago. In order to meet those monthly payments, a family would need an annual income of almost $40,000. Only 19.5% of the American people have an income high enough to afford that home, and virtually no first-time homebuyers would qualify for a home at those interest rates.

At the same time, a long-term financial revolution is changing home financing. Deregulation of financial institutions has forced the mortgage market to compete directly with the more expensive capital markets for funds. To cope with an uncertain future, the adjustable rate mortgage appears to be replacing the level payment mortgage as the standard lending device. These changes will continue to impact hardest on the first-time homebuyer.

It is our belief that mortgage revenue bonds should become a major housing opportunity for low and moderate income families. It would not only help the lower income buyer directly by making available affordable level payment mortgages, but it would also stimulate the housing mobility necessary for a viable overall housing market.

AMENDMENTS TO THE MORTGAGE REVENUE BOND ACT

Simply stated, Mr. Chairman, the current statutory and regulatory framework for mortgage bonds don't work. Therefore, we support the necessary corrections to the program included in the bills introduced by Senators Sasser and Baker, S. 1348 and Senator Durenberger, S.1656. The amendments we support are no departure from the program approved last year. The intent of these amendments is to make the bond program work at the level of activity contemplated last year. The Joint Tax Committee has reported that the Sasser bill has no revenue impact and we expect the Durenberger bill would receive the same determination.

The most important clarification is to assure that the good faith test remains a test of good faith rather than an impossible standard of absolute perfection.

To market tax-exempt bonds, bond counsel must certify that the bonds are and will remain tax-exempt. The Congress required that 95% of the bonds must be used for "qualifying mortgages" meeting purchase price, principal residence, first time homebuyer and other restrictions. It was expected that state and local agencies would be able to bring any non-qualifying mortgages into compliance. However, the way the statute is interpreted by the Treasury, if more than 5% of the bonds are found to be ineligible the entire issue is taxable and taxable retroactively. This unlikely possibility requires bond counsel to issue a qualified bond opinion which makes the bonds very difficult or impossible to market. In reality, the Congressional - required restrictions should easily be met by more than 95% of the mortgages. However, no bond counsel can certify to that fact because it depends on future actions of persons out of his control -- loan originators and borrowers. Therefore, without an opportunity to cure unacceptable mortgages, bonds cannot receive an unqualified opinion and the bonds are not marketable.

This problem can be solved by allowing issuers the opportunity to cure unqualified mortgages. Both bills, S.1348 and S.1656, remedy the good faith problem in slightly different ways. The Sasser bill would allow the issuer to rely on a buyer's sworn statement, whereas the Durenberger bill would require audits and prosecution of fradulent buyers but both bills would would require the issuer to cure the unqualified mortgages. Both bills are acceptable but the Sasser bill is preferable because it would require less administrative cost. This could mean lower mortgage rates or less direct financial contribution by the issuers.

We share the concern of this Committee that the arbitrage limitation should be as low as practicable consistent with a workable program. Arbitrage, in the case of mortgage bonds, is the difference between the interest rate of the bond and the mortgage interest rate. Of course, it is in our best interest to provide the lowest mortgage interest rate possible. All other tax-exempt issuances are allowed a 1 1/2% spread, whereas by statute these mortgage revenue bonds are limited to 1%.

The Congressional Budget Office has said "unless that spread is at least 1.5 percentage points, there is not enough difference between what the locality takes in and what it pays out to cover administrative cost"* It is clear from our situation in Florida and from talking with representatives from other states that the 1% yield limitation in the present law results in insufficient cash flow to perform the cost of administering the issue without an equity cash contribution on the part of the issuer. There is nothing in the legislation or the legislative history that indicates that Congress intended cash contributions by issuing agencies. Some states, especially those with a long history of bond issuances, may have a limited amount of reserves to contribute for their next bond issuance. But they cannot continue such a practice indefinitely. Many states are prohibited by their State Constitutions from making such contributions and my state agency in Florida, like many others, is too new to have builtup any reserves.

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* Tax-Exempt Bonds for Single-Family Housing, A Study Prepared by the Congressional Budget Office for the Committee on Banking, Finance and Urban Affairs, House of Rep. Committee Print 96-2, April, 1979,p.5.

In addition, under the good faith requirements as interpreted by Treasury, the administrative costs are even higher than for other bonds. We urge that the arbitrage limitation be raised sufficiently to make issuances viable. I believe that our state could operate with a spread of between 1 1/4% and 1 1/2%. I understand that in some communities 1 1/2% is barely sufficient. We urge the Congress to end the discriminatory treatment against mortgage revenue bonds by reinstating the 1 1/2% provision for mortgage bonds.

Another problem that makes the arbitrage limitation so unrealistic is the requirement for registration of the bonds. No other bonds require registration. According to our bond underwriters, this discrimination has the effect of adding approximately 50 basis points to the marketing of such issuance. We ask that the discriminatory impact of the registration be eliminated as recommended in both the Sasser and Durenberger bills.

A problem with the regulations for our state and many others is the purchase price limitation. The Treasury and the Department of Housing and Urban Development, established "safe harbor" prices for new and existing homes that would be considered within the statutory limits. However, the purchase price limit for my area of Florida has been set higher for existing housing than for new housing. I believe this is due to the fact that HUD considered condominiums as single-family homes instead of defining single-family homes as 1-4 unit housing. The large number of small retiree condominiums in my area has so distorted the data that building single-family housing under the mortgage bond legislation is impossible. We urge the Committee to consider an amendment that would define single-family homes as 1-4 units as it is defined in the basic FHA statute, Section 203(b) of the National Housing Act.

Other technical changes concerning the treatment of prepayments and targeted areas will be dealt with by other witnesses. I would, however, ask that the Committee consider one change in the spirit of fairness. In the Mortgage Bond legislation, the Congress and certainly this Committee, intended the single family bonds would operate for three years. We are fast approaching the first anniversary of that legislation without any viable program. We believe the clear legislative intent of a three year test of targeted single-family mortgage bonds has been frustrated by the interpretations and delays by Treasury. We believe it would be only fair to establish the sunset three years after workable regulations are effective.

MULTIFAMILY

The multifamily rental construction market is in a state of depression. Essentially no units below the luxury market are being built without subsidies. Low-income housing requires tenant subsidies and either tax-exempt or other federal assistance for the permanent mortgage.

The demand for affordable rental housing is very strong. Vacancy rates are at record lows. Forty percent of the rental stock is between 40 and 100 years old. A major factor in the shortage of rental housing is simply the tenant's inability to pay enough rent to cover the building's mortgage payments and its operating costs. For the foreseeable future tax-exempt financing or other federal financial assistance will be necessary for low and moderate income projects.

We would normally feel uncomfortable testifying in support of changes in legislation until the responsible department has published regulations implementing the program. But after 11 months, Mr. Chairman, we do not have the luxury to wait for the Department to act. The multifamily amendments are in no way as complicated as the single-family program. And it is our understanding that these regulations will not be out soon. We ask that this Committee use its best efforts to get those regulations published as quickly as possible.

We have a real concern that when the regulations are issued, statutory amendments will be required. The Durenberger bill addresses two of the areas that may need clarification and we urge their adoption. Under the Act, the income limit is based on the statutory definition of Section 8 eligibility which was 80% of median. This definition was subject to debate and alteration during consideration of the assisted housing portion of the Budget Reconciliation process. Chairman Dole spoke on the floor of the Senate in recognition of the possible problems caused by that change and stated that no change in Section 8 eligibility should affect the definition in the tax-exempt program. The Durenberger amendment would further clarify this issue by statute by defining low-income as 80% of area median.

Another issue clarified in S.1656 deals with the length of time 20% of the tenants must be of low income. The amendment would limit the term to the length of the time of the subsidy or ten years, whichever is greater. This protects the integrity of the low-income nature of these buildings but does not require the owner to subsidize units if the government at some time does not provide rental subsidies.

Since the law was passed, the future of Section 8 rental assistance is very uncertain. The Housing Commission and others are considering whether a broader use of tax-exempt financing should be the key to future federal rental housing construction programs. One program being discussed by our Housing Agency in Florida uses rent differentials based on tenant income and no federal subsidies. We do not think this is the time to consider broad changes in multifamily tax-exempt financing. However, there will likely be proposals in the next year for major changes in the federal role in multifamily housing and tax-exempt financing. At that time, we would like the opportunity to be heard before this Committee.

Mr. Chairman, our Association has supported the President's new round of budget cuts because we agree that a reduction in federal borrowing is needed to reduce interest rates. At the same time, we reject statements from Treasury that tax-exempt financing for shelter needs is inefficient, provides few social benefits and increases the federal deficit.

We believe tax-exempt financing is perfectly consistent with the philosophy of this Administration. Tax-exempts are issued independently by state and local governments to fill particular housing needs of the various areas within a state. They provide lower cost financing to those most in need but rely on privately developed housing.

According to the supply side economic theory, the use of the bonds will result in greater productivity and revenue back to the Treasury from taxes. NAHB estimates that for every $10 billion in new housing construction generated by revenue bonds will create:

- at least 310,000 new units
- 370,000 man years of work
- $ 625 million in Federal income tax
- $ 346 million in Federal Corporate income tax
- $ 85 million in State income tax
- $ 216 million in local real estate tax
- $ 6.9 billion in indirect wages

This stands in contrast to the revenue loss of $400 million estimated by Treasury for FY'82.

S.425 introduced by the Chairman demonstrates the problem of national legislation attempting to regulate an ongoing successful local and state program. S.425 would exempt from the Mortgage Subsidy Tax Act veterans bonds from Oregon. Oregon set different targets for the bonds than the federal government and thus ran afoul of the federal restrictions. The special problems of Oregon deserve to be dealt with as part of this legislative package on revenue bonds.

Mr. Chairman, there are very few actions Congress is able to take this year that would result in increased housing production in the near future. No more important opportunity exists than the creation of a workable bond program. These few needed modifications can make this program work to get housing built and get people into affordable shelter. We urge this Committee to move as rapidly as possible to approve this legislation.

Thank you for the opportunity to present our views on this issue. I would be pleased to answer any questions you may have.

Senator **Durenberger**. I wasn't here for Buck's testimony, but it is interesting, having come to the Finance Committee in the middle of the term of another administration I formed one opinion of Treasury and their role in making public policy, and it was interesting to sit here in January and February of this year with a new administration, new policy people, and a new IRS head, and so forth, and hear all the questions from up here about who really makes policy in this country, and hear the responses from down there: of course, you do, Senator. And then during the process of tax reform and tax cutting and so forth in July, in a total sense of cooperation, and what can we do to accommodate your role in making public policy. And now that all that is behind us, I am beginning to see some of the old Treasury that we saw before. But as far as Buck Chapoton himself is concerned, I think he is a tremendous individual, and I think his heart is basically in the right place.

I want to ask you a couple of questions about multifamily, all of you, and particularly those of you who didn't comment directly on it as Jim did. I think Buck is probably caught in the position where we all know the administration is going to do something on IDB's, and so he just says, why don't we wait until we do the IDB thing. But you people know what the realities are of the shelter marketplace out there. You also know the realities of the impact of what we did in accelerated depreciation as a sort of a partial incentive. But I just felt it was essential as we put this bill together to go into some of the key areas of multifamily that appeared to everybody to be a problem, one of them being the definition of "low income" and the other one being the business of the occupancy requirement, which we are trying to find some reality in that area. And I wonder if each of you would comment briefly sort of in response to the chairman's question a little earlier: there's only so many things you can do. How would you prioritize them, to have you put the multifamily provisions in my bill into that sort of priority perspective?

Mr. **Holmes**. Well, I think the term provision that I mentioned would rank as the most critical. I am finding, interestingly, that there is, perhaps because every other avenue has been shut down, locally renewed interest in trying to find a way to make multifamily rental work. A lot of innovative thinking is going on. The stumbling block seems to be, at least as I hear it, the 20-year requirement, or at least what has been interpreted to be the 20-year requirement. It is just too long a period of time to tie up the developer and have that kind of a covenant on the project, given the tax consequences and so forth. And so it was that aspect of the bill which I thought would be the most helpful, Senator.

Senator **Durenberger**. Mr. Brophy?

Mr. **Brophy**. Senator, I think the current situation on multifamily is that the 20-year requirement, plus the curtailment of the section 8 program, are rendering this component generally infeasible. The provisions in the Durenberger bill that would permit an internal subsidy for 10 years, and a subsidy half the length of an issue I think would make this a very attractive program for the HUD moderate rehab section 8 program, which has a 15-year housing assistance payment contract, and would be very helpful in making the multifamily component more feasible.

I do think, too, however, that even in addition to those changes, when you have a small building, say 1 to 10 units and in Pittsburgh, about 75 percent of our rental housing stock is in that category, and it needs rehab.

Senator **Durenberger**. Did you say 10 units?

Mr. **Brophy**. Ten or less. That it seems to me that some form of an exemption for those buildings from the 20-percent requirement, in any form, is something that would be very useful. When you have a 10-unit building, getting a section 8 unit, or a couple of section 8 units for that building, is not worth the paperwork, and it just is too costly to go through. The numbers do not work particularly well to try to get eight units to subsidize two, or even in the smaller building, six units to subsidize one or two. So an exemption for small buildings to permit tax exempt financing to work without any requirement that an *x* percentage go for some period of time to low and moderate would be very helpful in allowing rehab of the small rental housing stock in many of our cities.

Senator **Durenberger**. Mr. Arbib?

Mr. **Arbib**. Senator, I want to say that your bill addresses the two issues that our agency has found to be difficult, especially with the phasing out of section 8 housing. We have been looking into the possibility of sort of self-subsidized multifamily where rents could be skewed so that the 20 percent would be paid for by the 80 percent, and the changing of the definition of an eligible person is an essential ingredient to making that possible. And, of course, the length of the time has been addressed.

One thing that I would like to mention, and that is, the Secretary when he was here, mentioned that he understood these two problems, and Treasury seemed to agree with them, but he wanted to wait until legislation regarding industrial development bonds came out. I am a little bit concerned because I hear rumors that there is going to be legislation to do away with industrial development bonds altogether. And if mortgage revenue bonds for multifamily are in fact industrial development bonds—and I question that—then I would say that we definitely need legislation that makes it clear that they are not industrial development bonds, and certainly do not fall in the same category of those things which our legislator from Florida, Sam Gibbons, has spoken about on national television.

Senator **Durenberger**. Thank you all very much. We are into the lunch hour, otherwise we would ask more questions. Thank you for being here today. Your full statements will, of course, be made part of the record.

We have a final panel consisting of Moon Landrieu, former Secretary of the Department of Housing and Urban Development; and William Witte, Deputy Director of the Office of Housing and Community Development in San Francisco, representing the Conference of Mayors. It is nice to see you back.

Mr. **Landrieu**. Thank you, Senator.

Senator **Durenberger**. You may proceed.

STATEMENT OF MOON LANDRIEU, FORMER SECRETARY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. **Landrieu**. Well, thank you, Senator. I would like to direct my attention to two issues that have been touched on by Assistant Secretary Chapoton, that is, the definition of low and moderate income, and, second, and perhaps even more importantly, the ability to issue shorter term bonds. But before I do, Senator, I would like to correct the agenda which suggests that I am associate with Stroock, Stroock & Lavan. I would be honored to be so associated, but unless I have been placed on waivers, I am still with another law firm. But I am today, in cooperation with Stroock, Stroock & Lavan, testifying on behalf of Shearson—American Express to this particular issue.

The Assistant Secretary pointed out that these two issues were indeed technical, and felt that they could be corrected when we dealt with the overall issues involved with industrial revenue bonds. The problem with that, Senator, is that there isn't anything happening out there in low-income rental units. This committee is going to end up being the only production side that we have.

As the administration cuts back on section 8, we are left without a production incentive. A real production incentive, that exists, is the tax-exempt features for the financing. We have a remarkable economic system in this country, but it is very, very selective, and it is not going to invest where there is no hope of a return, and where the risk is exceedingly high. And that is the case in trying to provide low-income rental housing for the people of this Nation.

In adopting the last act, we apparently tried to give some relief to those who had in the pipeline projects which required 30-year bonds but which had only 20-year contracts. Congress placed in the law—I think somewhat inadvertently, though well intentioned—the provision that said that even though you have a 30 year bond, you only have to maintain the commitment for the low income for 20 years. That is because we linked the tax exemption with the section 8. We completely overlooked the fact that there is indeed a private marketplace that exists out there without the subsidy which could conceivably work. And we think it can work without any direct Government subsidy under section 8, but not if we have to maintain that private subsidy, if you will, for the 20-year period.

We do not see anything wrong at all with tying the length of the subsidy to the length of the benefit. If you have a 20-year bond, then you ought to provide for the low-income families for 20 years. But that need not be the only way in which it can be approached. Where we are prepared to issue bonds, and believe the marketplace will accept them, in order to get some low-income families started, it seems to me quite appropriate to issue shorter term bonds, whether that be 7 or 10 years, whatever the marketplace will accept, and thereby produce some housing for this Nation, which is not going to be produced between now and January 1, 1984, for no reason other than there is a technical provision sitting there which I do not think Congress intended to apply.

The other feature, Senator, is the low-income definition. As we redefine low-income eligibility for section 8 to 50 percent, it now creates a hiatus, and I think that technicality should, unquestionably, immediately be corrected.

To give you some idea, Senator, if I can grab hold of the figures, the difference in long-term financing can amount to as much as 2 percent in the difference between a short-term bond and a long-term bond. And when that is fed into the rents, which have to be charged, it has a very significant impact on the affordability of those units for the low-income renter. For instance, average interest rates for tax-exempt bonds for housing for the week of October 8, 1981, long-term bonds were going for, on AAA, 12.8 percent; 10-year bonds were going for 12.25; and 5-year bonds were going for 10.75, the difference obviously being that you are at risk for a much longer time. And in uncertain markets, the investors want that additional protection. Those 2 percentage points on large projects make a very significant difference. And I am fearful, Senator, that without some incentive, there will be no, or certainly extremely little, housing built for low- and moderate-income Americans. And, therefore, I urge you to act quickly to correct what I think are two inadvertent technical aspects of this law.

Senator DURENBERGER. Thank you for your statement. And if there are more appropriate statistics that relate the rate to the term on that sheet that you just testified from, we will be happy to make that part of the record because I think that was a very appropriate point that you made.

[Statement of Mr. Landrieu follows:]

STATEMENT BY MOON LANDRIEU

Senate Finance Subcommittee
on Taxation and Debt Management
October 16, 1981

Technical Amendments Concerning Multi-Family Rental Housing Under the Mortgage Revenue Bond Act of 1980

Mr. Chairman, Senator Long, Senators, I appreciate the opportunity to testify today on matters of the utmost importance for our national housing policy. Although my testimony will focus on issues of great significance, you will be pleased to know that I will recommend only technical corrections to present law to help achieve the goal of increasing housing stock for low and moderate income families.

As all here today are keenly aware, our Nation faces a housing crisis. I have dealt with this dilemma first in my eight years as Mayor of the City of New Orleans, and then on a daily basis as Secretary of the Department of Housing and Urban Development, charged with the implementation of national housing policy.

This crisis is demonstrated most acutely in the sharp decrease in rental opportunities, the primary housing resource for those most in need. Moderate and low income families have been priced out of the market for homeownership, and ever more must rely upon rental units for shelter.

Nevertheless, since 1976, new rental construction has decreased by 75%, to the point today where construction for unsubsidized units is virtually non-existent. Vacancy rates for rental units have run this year at about 5% nationally, but even more dangerously low in large cities all across the country: Miami, below 1%; Los Angeles, 1%; Chicago, 2%; New York City, below 3%; Boston, Seattle and Atlanta, below 5%; and finally my own New Orleans, less than 1%.

Only government-supported rental projects are being constructed to address this dire shortage of rental housing stock. The primary program fostering rental construction for low and moderate income families is Section 8 Rental Subsidy Program of HUD. But is has proven very costly to the Federal Treasury. That is a fact of life which is politically unacceptable as substantiated by the recent severe cut backs in Section 8 appropriations, and will soon lead to the program's total demise.

It is now incumbent upon us to pursue alternatives for the provision of housing at modest prices which low and moderate income families can afford. Private industry must still be relied upon, as it has been under the Section 8 program. But more economic and efficient means must be established.

Recognizing this situation, I followed the changes Congress enacted last year in the tax laws affecting multi-family mortgage revenue bonds. I felt at that time, and still do, that the set aside in each project for low and moderate income individuals was appropriate national housing policy. However, there was a technical provision inserted which must be corrected in order to provide the means for a very limited Federal subsidy-through tax exemption of these bonds-to meet the housing needs of low and moderate income people as well as to increase the multi-family housing supply across the country.

My understanding of the intent of the 1980 Mortgage Revenue Bonds amendments was to insure legitimate public purpose in return for the tax exemption: namely, to generate expanded rental supply and to create housing opportunities specifically for low and moderate income people. The fact that this intent was not met can be demonstrated as follows;

1. As HUD Secretary, it was my firm understanding that the 20-year retention of the low income requirement (as contained in the three year transitional rule) was never meant to limit the term of the bond to be issued. Rather, the intent of this temporary rule was to allow those developers with Section 8 contracts to issue 30 year bonds. At the time the initial bill was written in 1979, everyone assumed that the low income units would be subsidized by a Section 8 contract from HUD which usually run for 20 years. (I can attest to that by all the communications I received as Secretary of HUD.) Since mary projects at that time were financed with 30 year tax-exempt bonds, you had the situation where a developer would be faced with a rental contract covering only two-thirds or one-half of the 30 year term. Therefore Congress intended that the low income requirement need "only" be met for 20 years when longer term bonds are issued. But the actual language says "shall be 20 years." This means, in the opinion of most bond counsel, that shorter term bonds cannot be

issued with such a 20 year requirement. Indeed, the fact that the Section 8 Moderate Rehabilitation Program carries a statutory 15 year subsidy contract flatly contradicts the Mortgage Revenue Bond's new 20 year requirement.

2. Most importantly, it obviously was never the intent of Congress to hamstring housing projects meeting the legitimate public objective of setting aside 20% of their units for low income families--without Federal rental subsidies--from being financed with Mortgage Revenue Bonds. Nonetheless, that has been the result of the 1980 law's 20 year term requirement, and only two Mortgage Revenue Bonds of this kind have been sold since its enactment.

Currently, in my own area of New Orleans, two Mortgage Revenue Bond projects, one involving 1,500 units and the other 400 units, are both well along toward fruition without any reliance on the Section 8 program. Yet, they can go no further on these projects to fulfill the dire need for affordable rental housing unless the technical correction I am recommending today is made promptly.

These projects will meet the 20% occupancy set-aside for low income families, and these families will pay only that amount of their incomes for rent which they would have been required to pay had a Section 8 contract been employed. Over-all, the units will be rented by middle and low income tenants, with no "penthouse suites for the wealthy."

With respect to the unwarranted and unintended linkage bewteen the tax exemption for Mortgage Revenue Bonds and Section 8, it is noteworthy that New Orleans has seen its allocation for Section 8 new rental construction cut from 1,169 units in 1980 to 649 in 1981. It will undoubtedly be below 400 units in 1982. The total from these two projects alone would absorb the City's entire Section 8 allotment--and that was never intended either by the lenders, the developers, or the Congress.

Indeed, Section 8 new construction is now certainly on the way out. But the housing needs it sought to serve still remain. Lsat year Congress determined that Mortgage Revenue Bonds are an appropriate means to meet this need, and keeping the low income set-aside requirement coterminous with the length of the bond as Congress originally intended is the simple correction that is necessary.

Projects like those in New Orleans have been put on hold ever since the mistaken 20 year term requirement went into effect. The two year delay we are facing unless Congress acts now certainly will result in the termination of these projects as well as hundreds of others throughout the country.

I cannot stress too strongly the need for immediate Congressional action on this matter. This Nation faces a critical shortage of rental housing stock, and the Mortgage Revenue Bond projects that are on the drawingboard must be freed from last year's Congressional misstep in order to proceed to construction. Given this crisis, it would only compound the suffering of lower

Corrective Amendments

to the

Mortgage Revenue Bond Act of 1980

Two corrective/technical amendments are necessary in order to allow issuances to proceed. One concerns interpretation of the transitional rule expiring on December 31, 1983. The other is necessitated by recent action in the Budget Reconciliation Act which redefined HUD Section 8 eligibility.

1. Clarify the length of 20% low-income requirement. Until December 31, 1983 the 20% low-income requirement (15% in target area) shall be retained in each project for 20 years. As of January 1, 1984, there is no term specified and therefore would be read to mean the term of the bond no matter how long or short that might be. The temporary rule was added to allow those with Section 8 commitments at the time of enactment to finance with 30 year bonds. However, since most Section 8 contracts are for 15 years, it is preventing issuance of 20 year bonds as well as short-term bonds.

The proposed amendment would eliminate the transitional rule and require that on all issuances the requirement be met for the term of any rental subsidy contract and when no such subsidy is utilized, for the term of the bond.

2. Clarify the definition of "low or moderate income" to mean 80% or less of the area's median income. The Act requires 20% (15% in target area) of the units in each project be for individuals of "low or moderate income". It defines that income by referring to Section 167(k)(3)(B) of the Tax Code. In turn, that section refers to the HUD Section 8 program which at the time of this Act's enactment was 80% of an area's median income.

However, the recent Budget Act redefined the Section 8 eligibility and now the Housing laws refer to "lower-income" (80% of an area's median income) and "very low-income" (50% of an area's median income). In order to eliminate such confusion, Section 103 of the Tax Code should clearly state that "low or moderate income" means 80% of an area's median income.

Draft Corrective Amendments*

to

Section 103(b)(4)(A) Internal Revenue Code of 1954, as amended

(4) Certain Exempt Activities - Paragraph (1) shall not apply to any obligation which is issued as part of an issue substantially all of the proceeds of which are to be used to provide:

(A) projects for residential rental property if each obligation issued pursuant to the issue is in registered form and if:

(i) 15 percent or more in the case of targeted area projects, or

(ii) 20 percent or more in the case of any other project,

of the units in each project are to be occupied by individuals of low or moderate income, for the term of the issue or in the case of units receiving any federal, state, or local rental assistance contract, for the length of the contract.

As used in this subparagraph (A) -- the term "individuals of low or moderate income" means an individual or individuals whose income at the time of initial occupancy is equal to or less than 80% of the area's median income.

Strike Section 1104(k) of the Revenue Adjustment Act of 1980, titled "Transitional Rule for Low or Moderate Income Requirements."

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*Underlined words are new language.

AVERAGE INTEREST RATES FOR TAX EXEMPT BONDS FOR HOUSING

Week of October 8, 1981 *

	AAA	AA	A
1 year	10.6 %	10.50%	10.75%
5 year	10.75%	11.0 %	11.75%
10 year	12.25%	12.50%	12.75%
Long Term	12.80%	13.0 %	13.25%

Note: Most bonds for housing are AA rated.

* As compiled by Shearson-American Express

Senator DURENBERGER. Our next witness is Mr. Witte.

STATEMENT OF WILLIAM WITTE, DEPUTY DIRECTOR, OFFICE OF HOUSING AND COMMUNITY DEVELOPMENT, SAN FRANCISCO, REPRESENTING THE CONFERENCE OF MAYORS, WASHINGTON, D.C.

Mr. WITTE. Thank you, Senator. My name is Bill Witte. I am deputy director for housing in the mayor's office of housing and community development in San Francisco, and I am appearing before you on behalf of Mayor Feinstein and the U.S. Conference of Mayors. I am also pleased to have the opportunity to share the podium with my former boss and colleague.

I would like to commend you, Senator, for your leadership on this issue over the past couple of years, and I think being well aware of what my colleagues under Mayors Lattimer and Frazier in St. Paul and Minneapolis have done, as you well know, is testimony to the fact that cities can be both creative and responsible in using this financing mechanism.

As with Secretary Landrieu, I am going to focus mainly on the multifamily side. And I am pleased to see that your bill does address that. That is clearly the greatest need in San Francisco which, as you probably know, has the highest housing cost in the continental United States, and basically no rental vacancy rate. And I think the most important point here is that we are just asking for technical clarification, not loopholes, not bailouts, not additional revenue loss. Much has been made of the notion of local or State contribution. And I think just for a little perspective, because it is instructive I think as to what cities are going through now, I would like to mention a few of the things that San Francisco is doing in that light.

First of all, we have set aside all publicly owned available surplus land, be it redevelopment, State, Federal, whatever, in the city for housing. We are giving special priority to any housing that can be developed for rental or affordable cooperative purposes. We have put massive amounts of community development money in, written down the cost of land. We are offering favorable lease arrangements. We are even building housing on top of three public parking garages.

In a perhaps more unprecedented move, the mayor has taken a rather controversial position of requiring commercial office developers as a condition for going ahead with their office buildings to build or contribute to housing, for which she has taken a lot of flak. But the point is that the only thing that is missing now is a viable financing vehicle. I think we have gotten to the point where everything else is ready to go.

And to reiterate a point that Secretary Landrieu and others have made, and that you mentioned earlier, it is critical that this be done now. And it is not that I do not trust the Treasury. I just think that you are a little closer to the issue. There is pent-up demand, as you know. We have, as I have mentioned, a local commitment in millions of dollars toward these sites, subcontractors waiting who are not going to wait any longer. And, again, I think it is fallacious to consider multifamily housing in the same category as other classes of industrial development bonds. There is lots of precedent throughout various Federal statutes for the public purpose embodied in that program. The problem again, I think, here, as has been mentioned, is that the current rule is unintentionally predicated on the section 8 program which will no longer be around in a year, thereby penalizing issuers such as San Francisco seeking to operate without it; and I might add, we are ready to move with a project that, as the gentleman from Minneapolis mentioned, has internal subsidies, where the higher income rents would subsidize the 20-percent portion. And, again, with a few technical corrections, we can proceed without any Federal funds.

And I might add, Mr. Brophy mentioned the section 8 moderate rehabilitation program and some other HUD programs which have 15-year contracts. We are working with a consortium of commercial banks to set up a pool of tax exempt financing for moderate rehabilitation of nonprofit owned residential hotels, many of which house Indochinese refugees. These could also move if that bond term were made a little more flexible.

So, again, your bill certainly goes a long way toward helping. We clearly support, as Secretary Landrieu mentioned, the clarification of the eligibility, the definition of low income. In fact, our bond counsel will not write a clean opinion until that is clarified.

We agree that the bond term must be made more flexible. I would reiterate the point that Secretary Landrieu made. Ten years is a step in the right direction. The market ought to dictate in terms of workability perhaps below that what really is appropriate.

I would like to raise one other point that has only been alluded to previously which is of great importance in California. We have two projects assisted by the State which you might call limited equity cooperatives. These are not Park Avenue cooperatives. Thirty-five percent of the cooperators would be below 80 percent in median. No one would be more than 120 percent in median. And I am sure you have seen some of the arguments for considering these as multifamily housing. A blanket mortgage. These units are locked into low and moderate, or middle income affordability forever because of deed restrictions placed in there. They bear far more resemblance to multifamily than single family bonds, and nobody I think could question the public purpose.

Finally, I think the National Association of Housing Cooperatives has demonstrated that the tax loss to the Treasury in that kind of a program is less than even under a multifamily rental. And we think it can be done through regulation, perhaps with a directive from the committee that that be also considered. I thank you.

Senator DURENBERGER. Thank you very much. I was intrigued by what you indicated about what the mayor is up to. I was thinking of the fact that in way out suburban developments we mandate set asides for parks and open space to save us some money, and in condominium developments we take care of certain of our transportation and parking needs. And I suppose this would only apply in certain kinds of communities. But there is an awful lot of appropriateness to the notion that there are an awful lot of public savings and energy consumption and transportation and a variety of other things in bringing the commercial developers in the city area, at least part way into the business of shelter.

And I appreciate the testimony from both of you with regard to both the imperatives and some of the logic that is involved in multifamily.

On the business of the internal subsidization, have you some notion of the length of the term of the bond that would be necessary in order to internally subsidize without any Federal subsidy other than the tax-exempt status?

Mr. **LANDRIEU**. Senator, my guess is that it works somewhere around 7, 8, 9, 10 years. When you hit 10, you are bumping up against what I think are the limits. Now, it is anyone's guess as what the limits are. But it seems to me it makes eminent sense to let the marketplace determine that. There are ways in which the availability of those units can be preserved to that individual who moves into that unit. It doesn't seem reasonable to say, however, that if we cannot preserve it for 20 years, either in the name of this individual or some other low-income person, then we don't want the units built.

The marketplace will respond, but the marketplace cannot be hampered as it is with that restriction. But we think it will work with internal subsidy at about 7 years.

If we were to do that, then it seems to me the very least we would do is produce low-income housing for 7 years. And, hopefully, others will be coming on stream. And there are even ways beyond that in which the individual would not be displaced but could be protected. That always being the fear that someone would take advantage of the tax-exempt nature and then not fulfill the public purpose. But it seems to me the public purposes were filled by the mere construction of the units, first, and then the preservation of that unit for at least the 7-year period. And if the Congress wanted to go further—and I would not recommend it—but if you wanted to go further, I would absolutely nail it down. Some other provisions could be written in for the protection of the individual rather than the class. But I think it is essential, Senator, that you do undertake this now.

Mr. **WITTE**. Senator, I would just add that the State of California itself already has passed legislation, Assembly bill No. 665, which requires the low-income portion staying low income for 20 years. So we have no choice there.

What is key, and, frankly, in a strong market like San Francisco, we feel we can make the deal work there. So that is fine. It may not be true in Oakland or Detroit. But the important part is that the market rate portion must, as Secretary Landrieu said, be able to float with the market. We have run numbers with developers. It works at 7 or 8 years. It may work at 10 years. I mean, it is difficult to set a fixed number.

Mr. **LANDRIEU**. May I add a statistic, Senator, that you seem to be interested in? And I only read two from this sheet, and these were prepared by Shearson—American Express. If you looked at AA bonds, which are that classification which covers most housing issues, the difference between a 10-year bond and a long term, the long term being something over 10, but I would take it substantially over 10, the difference is that the long-term bonds require 13-percent interest and the 10-year bond requires 12.5. However, when you get below that 10-year period into the shorter yields, at 5 years it falls all the way down to 11. So the differential between the 10-year bond and the long-term bond is only one-half a percent, whereas, it falls off rather dramatically after that. I don't know the reasons for that; it is just the nature of the market. But I will submit this for the record. And I think an examination of these figures would make a very strong argument for something less than 10 years.

[The information follows:]

TESTIMONY OF WILLIAM WITTE
DEPUTY DIRECTOR, MAYOR'S OFFICE OF HOUSING AND COMMUNITY DEVELOPMENT
CITY OF SAN FRANCISCO
ON BEHALF OF U.S. CONFERENCE OF MAYORS
BEFORE THE SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT, SENATE FINANCE COMMITTEE

16 OCTOBER 1981

Mr. Chairman and members of the Committee, I am William Witte, Deputy Director for Housing in the Mayor's Office of Housing and Community Development in San Francisco. I am appearing before you today on behalf of Mayor Dianne Feinstein and the U.S. Conference of Mayors.

The Conference of Mayors has long advocated a responsible approach to the issuance of tax-exempt mortgage revenue bonds, as a means by which cities can fashion efficient and cost-effective housing programs without massive involvement of the federal government. While the Conference and the City of San Francisco are deeply troubled by the impending withdrawal of federal support for low--and moderate-income housing, I appear before you today not to ask for dollars, special exemptions, or loopholes; rather, I am here to recommend some technical amendments to, and clarifications of, the Mortgage Subsidy Bond Tax Act of 1980, which, if enacted would simply enable cities to carry out the provisions of the law. I am pleased to have the opportunity as well to comment on S.1656, which I believe represents an important step toward relieving the problems we currently face.

My testimony today is intended to demonstrate how cities such as San Francisco are attempting to make creative use of local, state, and private sector resources to meet increasingly critical housing problems, and how the technical amendments I will propose will enable those efforts to produce immediate results without a drain on the federal Treasury. I will concentrate my comments on proposed modifications to the rules governing tax-exempt financing of multifamily rental housing; the Conference of Mayors shares the concerns involving provisions of the law governing single-family obligations which other witnesses will address in greater detail. In that light, we support the provisions of S.1656 which would apply a "good faith" test to the so-called 95 percent rule, increase the allowable arbitrage limit from one percentage point to one and one-quarter points, and eliminate the costly and inefficient requirement that bonds be registered. These technical modifications would help San Francisco to proceed with an innovative $60 million single-family issue, in which $20-25 million in corporate and pension fund investment would be combined with the bond proceeds to form a pool of shared-appreciation mortgages for moderate-income first-time homebuyers, in the process financing 600 units of new housing in the city.

I have read a recent report that there is currently an adequate supply of rental housing in this country, and, therefore, no need for federal support in this area. Surely the authors of this report did not have San Francisco in mind in drawing their conclusions. Consider the following:

1) The vacancy rate for rental units in San Francisco today is under one per cent. Over 500 low-income persons with guaranteed certificates paying market-rate rents under HUD's Section 8 existing program have been unable to find housing.

2) The number of households competing for housing in the city increased by nearly 20 percent between 1970 and 1980. Demographic trends suggest that this demand will continue to increase through the 1980's.

3) Two-thirds of San Francisco's 670,000 residents are renters. While increasing homeownership opportunities in the 1970's tended to relax some of the pressure on the rental market, record-high interest rates have choked off these avenues, heightening the already fierce competion for rental housing. Similarly, only one nonsubsidized rental project has been built in the city in the last five years, despite the enormous and growing demand.

4) With over ten million square feet of commercial office space in the "pipeline," we expect a steady influx of people who will be working in those office buildings, and adding to the demand for affordable housing.

These phenomena are not unique to San Francisco. They are occurring in cities across the country. To gain the proper perspective for the recommendations that follow, however, I think it is instructive to look at what we in San Francisco are doing to help ourselves:

1) Earlier this year, the Mayor asked the City Planning Commission to inventory and reserve for housing all available publicly owned sites in the city. We have targeted several of these sites for multifamily rental and cooperative development. These include three public parking garages on which moderate-income housing would be built. In these cases, we are offering developers a package of incentives, including land write-downs, density bonuses, site improvements, and favorable lease arrangements, all at significant cost to the city.

2) In an unprecedented action intended to address the demand for additional housing generated by workers in new office buildings, the City Planning Commission is requiring commercial office developers to build or contribute toward the construction or rehabilitation of housing as a condition for approval of their office projects. To date, the Commission has received commitments for over2,000 units of housing, and direct investments in projects containing over 600 units.

3) The City has secured state assistance to underwrite the construction of two mixed-income, limited-equity cooperatives, totalling 182 units. One site is located in a Redevelopment Area, and the other is on surplus city land. In each case, the city is contributing the land at virtually no cost, in order to produce affordable housing. (Cooperative shares would be offered for $65,000-$75,000, in a city where median home purchase prices exceed $130,000)

The missing piece in each of these instances is a workable tax-exempt financing vehicle for multi-family housing. With it, San Francisco could help to generate over 2,000 units of affordable housing in the next couple of years. Without it, we will likely remain at square one: a total of 850 units of new housing of any kind were started in 1980 in the city.

We believe the following technical amendments to the Mortgage Subsidy Bond Tax Act of 1980 could substantially improve the climate for the issuance of bonds to finance affordable rental and low-cost cooperative housing:

TERM AND APPLICATION OF THE LOW-INCOME OCCUPANCY REQUIREMENT

Term of the Bond:

Present Law

Under the Mortgage Subsidy Bond Act of 1980 provisions are made to allow financing of residential rental property under certain restrictions. One restriction requires that 20 percent or more (15 percent in the case of targeted area projects) of the units in each multi-family rental project are to be occupied by individuals of low or moderate income (using the eligibility standards of the Section 8 housing program). A provision applying only until January 1, 1984 requires this low and moderate occupancy rate be for a period of 20 years. Consequently, the 20 year period applies only to December 31, 1983, at which time the Section 8-type occupancy requirement is presumed to be for the period the tax-exempt obligations are outstanding.

Problem

Treasury has indicated that it ill interpret this very literally, which would produce erratic results over the next three years. The impact of such interpretation and the legislative history suggest that a literal interpretation was not the intent of Congress.

The impact of the 20 year requirement will be to inhibit if not eliminate the availability of any tax-exempt financing shorter than twenty years. For example, if the bonds had a 10 year maturity period, and the low and moderate income occupancy levels fell below the statutory requirement after the bonds matured, the anomalous result would be that the bonds would become taxable after maturity. Not only is this a major departure from the Internal Revenue Code, but it is unlikely that bond counsel initially would certify the bonds as tax-exempt if future unforseeable events could alter that status.

Second, the committee reports indicate it was intended that financing for longer than 20 years would only have to meet the Section 8 test for twenty years because of the limited availability of Section 8 subsidies. It seems clear that the intent of Congress in enacting the 20 year requirement was to accommodate long-term maturities rather than restrict short-term maturities. (Report of the Committee on Ways and Means of the U.S. House of Representatives on H.R. 5741, Part B.)

Third, fulfilment of the public purpose--creating low income housing--is undermined by foreclosing the possibility of those projects which can meet the 20% low income requirement without Section 8. Given the severe cutbacks in Section 8 subsidies for FY 82 and its predicted demise, modifying the 20 year requirement for the 20% low income only to mirror the length of the Section 8 subsidy would probably mean that no low-income housing would be built under this program in the near future.

Fourth, the Federal interest is fully protected by shorter term tax-exempt financing. Shorter maturities are both at a lower annual as well as cumulative cost to the federal government. Because there is a supply shortgage of rental units and small-sized ownership units, shorter maturities should be encouraged if they result in new unit construction.

The effect of literally interpreting the 20 year - 20 percent requirements and their legislative history indicates some change in the act is desirable. Solution: The provision in S.1656 which would reduce the required term of occupancy to a minimum of ten years, the expiration of a period equal to one-half the term of the tax-exempt obligation, or the date on which Section 8 assistance to the project is terminated, would go a long way toward correcting these problems. Its benefits would be significant:

1) It would enable cities, such as San Francisco, which are contemplating meeting the 20%/15% requirement without Section 8 assistance to proceed, and at less cost to the federal government.

2) It would permit tax-exempt financing to be utilized in conjunction with HUD's Section 8 moderate rehabilitation, property disposition, and loan management programs, which have 15-year contract terms. These programs are frequently used to make viable older FHA-insured projects which have either been foreclosed on, or are threatened with foreclosure, and represent an enormous financial burden to the federal government.

Again, the key point here is to permit a flexible bond term, not to avoid the low-income requirement. (California recently passed legislation (A.B.665) which would require a 20-year commitment for the low-income units). In sum, this amendment would eliminate the transitional rule, and allow the term of the bond to be linked to the term of any rental subsidy contract, or permit an issuer the flexibility of meeting the requirement without federal subsidies.

Occupancy Requirements: S.1656 does not address a serious constraint in the Act created by the application of the low-moderate income occupancy requirement in areas with depressed housing markets and/or heavy concentration of low-income people. The act again presumes the continuation of the Section 8 program. Without such assistance, few, if any, cities are likely to be able to finance rental housing,in precisely those neighborhoods most in need of financial assistance.

The Conference of Mayors believes strongly that it is inequitable and inappropriate to deny Baltimore, Newark, Detroit, and other cities which have shouldered an inordinate share of the low-income population the ability to achieve economic integration through tax-exempt financing of market-rate rental housing. Elimination of the low-moderate income requirement altogether in target areas, as defined in the 1980 act, could help redress this imbalance without permitting wealthy communities to avoid their responsibility to provide affordable housing.

Low-Income Tenant Eligibility Criteria: S.1656 would clarify the definition of low-and moderate-income individuals rather than linking the definition specifically to the Section 8 law. We support this technical correction.

The 1980 Mortgage Revenue Bond Act defines "low income" by referring to Section 167(k)(3)(B) of the Tax Code. In turn, that section refers to the HUD Section 8 program definition as embodied in the Housing Act which, at the time of enactment of the 1980 Mortgage Revenue Bond Act, was 80% of an area's median income.

However, the FY 82 Budget Reconciliation Act enacted this year changes the present Section 8 definition for "low income" from 80% of local median income levels. The new formula contains a definition of "low income" as 50% to 80% of the median, and "very low income" as less than 50% of the median. For Section 8 projects, 10% of the tenants must be low income and 90% very low income, but the formula must be implemented nation-wide (i.e., the requirements need not be fulfilled project-by-project but merely in terms of the national aggregate).

Although there is conference report language indicating that these new eligibility requirements are not to apply to the Mortgage Revenue Bond program (it would be impossible to administer for Mortgage Revenue Bonds generated by dozens of state and local governments), the Internal Revenue Code was not amended to reflect this intent.

The law must be clarified for the local and state application of Mortgage Revenue Bonds. Currently, most bond counsel are reluctant to give a "clean" opinion on certain multifamily financings without this clarification.

BLANKET MORTGAGE LIMITED EQUITY COOPERATIVES

In high-cost areas such as San Francisco, we have sought an alternative means of providing long-term affordable housing through the development of cooperative housing which has legal restrictions on limits on the appreciation a share-holder can obtain upon sale on transfer of a coop. share. These projects have been considered as rental housing both by HUD and the State of California. We strongly believe that the IRS should accord them similar status, for purposes for tax-exempt financing. As exemplified by our two projects in San Francisco, the reasons are as follows:

1. The mortgage is blanket; i.e., covering all cooperators.
2. There is financial interdependency between the cooperators; i.e., the default of a few will affect all the other shareholders.
3. Cooperators normally have equal voting rights; i.e., one share-one vote, as opposed to proportionate interests based on market value or square footage.
4. The subscription fee is low; e.g., 2-3%, and can approximate the up-front payments on a rental for first-and-last-months' rent plus damage deposit.
5. Under Section 216 of the Internal Revenue Code, a cooperator may receive a distributive share (various methods are used) of the exemption for real property and interest expenses. However, the exemption is granted to the association since it pays a single tax bill on a single assessment and, similarly, interest on one note.
    a) In San Francisco's case, the benefit of the interest and real-property tax passback is particularly slight since the income-tax brackets of the residents are low:

Partially assisted - Income may not exceed 120% of median income for the San Francisco Bay Area

Fully assisted - Two-thirds cannot exceed 50% of median income

One-third cannot exceed 80% of median income

6. Limited - or structured-equity co-ops are specifically structured by by-law to virtually eliminate speculation and thus to retain housing in the original condition of truly low-and moderate-income. The greater the restriction, the more the co-op becomes a de facto rental, subject to the all-important long-term right-of-occupancy.

In closing, I would like to leave the Committee with a number of observations. First, we are all hoping that the various fiscal and monetary policy initiatives bear fruit in the form of lower interest rates in the short term. I can assure you, however, that we cannot afford to wait any longer, and the price of inaction -- unmet and growing demand for housing, loss of construction jobs and local revenues, and the cost of construction and related industry equipment and inventory lying follow--may result in no recovery at all. That collective cost will exact an enormous toll in both human and political capital.

Second, I reiterate that we are not asking for bail-outs or hand-outs, only that cities be given a change to operate within the spirit of the law. The technical corrections we recommend can provide that opportunity.

I appreciate the opportunity to appear before you today. I would be happy to answer any questions the Committee may have.

Senator **Durenberger**. I take it there is some kind of a timeframe on that exhibit, so we would be happy to have it made part of the record.

The last question of both of you relates back to single family. And I appreciate your concentrating on the multifamily in your presentation. But just your impressions, and I suppose particularly yours, Mr. Secretary. in light of your past experience to the need for the changes in the good faith part of the revenue bonds and the arbitrage section, some reactions to them.

Mr. **Landrieu**. Senator, I wish I could help you with that. I don't feel that I am knowledgeable enough in those fields or current enough to be able to be of any assistance to the committee on those points.

Senator **Durenberger**. All right. Mr. Witte?

Mr. **Witte**. Senator, we do have a single family issue in process very similar to Minneapolis/St. Paul's program, which would combine corporate and pension fund investment on top of the bond proceeds for shared appreciation mortgage programs.

Again, I think that is not an issue that varies from city to city or State to State. It is clear, particularly to us, that the 95 percent was clearly a problem, though we would not be the ones who enforce it. We could not get any of our local savings and loans to service this program until that was cleared up. So that I can tell you.

The arbitrage, again, I think is clearly a problem across the board. I don't think San Francisco has anything unique to add in that sense.

Mr. **Landrieu**. Senator, may I just bring you back for just one moment to the multifamily issue and point out that there are two projects in the State of Louisiana that are prepared to move forward and will be built providing 20 percent for low and moderate income if this technical change could be made. And I am sure there will be many, many others to follow. So it isn't just a question of theory. It is a fact that we can build some low- and moderate-income housing between now and 1984 if that regulation which was intended for another purpose will clarify them.

Senator **Durenberger**. Well, if 15 billion was a conservative market a year ago, I can imagine what it is today. And if 45 million is the actual by comparison, I am sure that you don't even have to prove to the record the pent-up demand that is out there. And I do appreciate the time that you have taken to prepare for today for your testimony. Thank you very much. The hearing is adjourned.

[Whereupon, at 12:47 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

State of Wisconsin \ DEPARTMENT OF VETERANS AFFAIRS
77 North Dickinson Street Madison WI 53702

Lee Sherman Dreyfus
Governor

John R. Moses
Secretary

October 14, 1981

The United States Senate
Committee on Finance
Subcommittee on Taxation and Debt Management
Senate Office Building
Washington, D.C. 20510

LMR:str

Attention: Mr. John Coldin

Dear Sir:

Enclosed you will find 100 copies of the comments of this department relative to Section 103A and IRS Regulations pertaining thereto.

If you have questions, please call me at 608/266/5567.

Sincerely yours,

DEPARTMENT OF VETERANS AFFAIRS

Lawrence M Reilly

Lawrence M. Reilly
Assistant to Secretary for Housing

Enclosures

Hire A Vet!

Comments of the State of Wisconsin, Department of Veterans Affairs, Relative to Section 103A and IRS Regulations Pertaining Hereto

The Wisconsin Department of Veterans Affairs (WISVET) was established as a separate state agency in 1945 to consolidate all state veterans' programs within a single agency. The department administers all state benefits to veterans and assists veterans in filing and pursuing claims with the Federal Veterans Administration. The department may, among other things, make economic assistance loans, home loans and educational and emergency grants.

The Wisvet Direct Home Loan program has provided more than 37,000 mortgage loans to veterans in Wisconsin. It has been funded by one billion dollars in general obligation bond proceeds, by revenue bond proceeds and by recycled funds, to a total of over $1,178,000,000.

Wisvet is presently operating a revenue bond funded qualified mortgage loan program, supports California and Oregon in their opposition to the regulations in their present form and very strongly supports the request by Oregon and California request for a change in Section 103A which would eliminate the Bond Registration requirement.

The department has many concerns with the regulations which relate to the restrictions imposed on qualified mortgage revenue bond funded programs.

We feel that Section 103A attempted to inhibit the issuance of housing subsidy bonds primarily through the purchase price limitations, prohibitions against refinancing, priority to first time home buyers and related controls and, of course, through an overall control on the total amount of dollars in bonds which could be issued by a state and by local governments within any state, and that residence and purchase price requirements should be considered satisfied if an issuer establishes that the property being purchased meets the purchase price requirements and that such property will be used primarily for the purpose of providing a principal residence for the mortgagors.

We are, therefore, especially concerned with restrictions on the amount of land which may be included with a residence to be financed with bond proceeds, the apparent blanket prohibition against the financing of a primarily residential unit, a portion of which will be used for business or commercial purposes, and the prohibition against using any bond proceeds for the acquisition of personal property.

EXCESS LAND

We propose that the regulations be amended to permit the ascquisition of land with a residence without limitation on the amount of such land, provided that the value of the dwelling unit exceeds the value of the land and that the applicant for a loan certifies that such land will not be used for farming or commercial purposes.

In the alternative, it is requested that the regulations specify a maximum size lot, e.g. one acre, which could automatically be purchased by a borrower on the basis of a borrower's certification that the land would not be farmed or used for commercial or business purposes.

If the issuer would be able to rely on such certifications in all cases involving lots of less than the maximum size permitted to be automatically approved by the IRS, it would relieve the issuer and its agents of the almost impossible task of determining whether applicants for loans who are purchasing residences located on other than minimum sized lots are acquiring more land than is reasonably necessary to maintain the livability of the residence.

BUSINESS USE OF PROPERTY

We also request that the regulations be amended to permit the use of a property for commercial or business purposes if the primary purpose for the acquisition of the residence is to provide housing for the loan applicant and the loan applicant's family. We feel that the regulations, as presently interpreted by bond counsel, discriminate unfairly against Avon ladies, Amway distributors, outside salesmen, and others who use a small portion of their homes for business or commercial purposes, either in conjunction with their principal employment or to provide incidental income, and request that the regulations be amended to permit applicants, who will use the majority of the properties purchased with qualified mortgage bonds for residential purposes, to qualify for loans on such residences.

If it is felt that blanket permission in the regulations for businesses in primarily residential units would not be supportable, we would have less objection to the regulations if they specified that residences to be purchased with qualified mortgage bond funds could not contain commercial or business units which would be open to the public and from which the purchasers of the properties would directly transact business with the public, but specifically permitted other business uses of such residences.

PERSONAL PROPERTY

Although the department insists that any personal property of value which is included with a residence be appraised and paid for by a borrower in addition to the borrower's required down payment, we have found that most personal property used solely for residential purposes usually has very limited value, and we have been amenable to accepting statements of "no value" in relation to such property from lenders and sellers. In addition to operating loan and grant programs, the department also operates the Wisconsin Veterans Home and has been responsible for disposing of the personal property of members admitted to this facility. We have received very limited sums for furniture of such members sold to second-hand furniture dealers, and the most we ever received for the complete furnishings of a household, including furniture and appliances, was slightly under $500.00.

Insofar as conventional sales of homes are concerned, most items offered to be left by sellers are items that they do not wish to move or would have difficulty moving. One example of such items might be a free-standing workbench with saw, or a drill press, or other items attached, which may have been a factor in sale of the house to the prospective buyer, but which could not have been moved without being dismantled. Another example might be inclusion of a large, free-standing, two-year-old freezer with a depreciated value of over $400.00 which was located in the basement of a house sold. The seller had constructed a recreation room in the basement, and enclosed the stairwell. In this case, both the doorway to the recreation room and the enclosures to the stairwell would have had to be knocked out and replaced in order to remove the freezer, at a cost greater than the value of the freezer so the freezer was "thrown into" the deal.

Further, when free-standing furniture or appliances are sold with a home, they are usually items which the seller will not be able to use at his future location and are not separately considered or valued in determining the sales price of the house, but, rather, are merely incidentals which the seller hopes will enhance the saleability of the house. To require the separate valuation of such items and the sale of such items by instruments separate from the purchase agreement for the residence would invite subterfuge and circumvention of the purchase price requirement, cause headaches for both the issuer and real estate appraisers, who are not experts in the appraisal of personal property. In our opinion, the regulations should provide for the permitted inclusion of such items in the purchase price.

For example, the department, which has operated its home loan programs under purchase price maximums for many years, enacted an Administrative Code rule which states, among other things, that drapes will not be considered personal property. This provision was enacted in order to prevent circumvention of the purchase price limitations because it was felt that veterans should not be permitted to circumvent the statutory cost maximums by purchasing draperies, for say $500.00, while paying the statutory maximum for their residences. However, drapes are not fixtures under the regulations in state law and it would therefore appear that the circumvention of the purchase price limits under Section 103A would be possible if buyers agreed to pay the sellers the appraised value of drapes in addition to the maximum purchase price of the residences permitted under Section 103A.

At the minimum, we request that the regulations be amended to state that any down payments made by borrowers will be presumed to cover the value of any personal property included with a residence and if a clearer statement of what constitutes excess land is not incorporated in the regulations, the value of any excess land included with a residence, so that we will not be faced with the possibility of a non-complying loan on the basis that qualified mortgage bond proceeds were used for the purchase of personal property or excess land, even though the value of the qualifying residence purchased by the applicant, exclusive of excess land and personal property, clearly exceeded the amount of the qualified mortgage loan because the borrowers' down payment covered the value of such land and personal property.

ASSUMPTION SALES

When a property is sold under a land contract, which is a contract pursuant to which possession and the benefits and burdens of ownership are transferred although legal title is not transferred until payment in full of the land contract balance, the land contract purchaser almost never assumes and agrees to pay the mortgage or make payments directly to the mortgagee. We request that the regulations be amended to state that a sale on a land contract where the purchaser had no direct liability to make payments on the mortgage not constitute an assumption sale under Section 103A.

We request that the regulations be amended to state that qualified mortgage loans may also be assumed by the heirs of deceased borrowers and by the divorced spouses of qualified borrowers who are awarded properties in divorce decrees on which there are qualified mortgage loans whether or not such spouses or heirs qualify as eligible persons under Section 103A.

Finally, we request that the regulations permit the origination fee charged for processing an assumption sale to be disregarded for the purpose of computing the effective rate of interest on the mortgages.

RESIDENCE REQUIREMENT

Many circumstances could prevent the occupancy of the residence as the borrower's principal residence, such as the death of the borrower after closing and before anticipated date of occupancy, termination of the borrower's employment and the obtaining of new employment during said period, the grave illness of the borrower's parent which results in the borrower moving in with the parent instead of occupying the property, the death of the borrower's parent making another residence available for occupancy preferable to the one purchased with bond proceeds, the death of the borrower whose income was being relied upon to make payments on the mortgage necessitating the resale of the property because payments could not be made on the property on the co-borrower's income, discovery by the borrowers that their children could no longer continue to attend school at a desired place of instruction, the partial or total destruction of the residence by fire, tornado, etc.

We, therefore, request that the regulation specify that if the intent of the borrower to occupy the residence at the time of the closing of the mortgage loan is established to the satisfaction of the issuer and the borrower's reason for failing to occupy the property within such reasonable period is found acceptable to the issuer, that the loan be treated as a loan which complied with Section 103A on the date the mortgage was executed.

95% RULE

If the issuer in good faith attempts to meet all requirements of Section 103A before qualifing housing bond financed mortgages are executed, and any failure of the mortgage loans to meet the requirements of Section 103A is corrected by accelerating the balances due on such loans and instituting foreclosure actions thereon or by eliminating such loans from the qualified mortgage bond loan portfolio, we request that the regulations provide that:

1. The "correction" or "cure" required by Section 103A has been accomplished; and

2. The loans be considered to be loans which were in compliance with the requirements of 103A at the time the mortgage pertaining thereto were executed.

DURENBERGER BILL

We request that Section 3 of the bill be amended to provide coverage of all mortgage loans made after its effective date.

Taxation and Debt Management Subcommittee of the Senate Finance Committee

Testimony of Colonel Gary E. Lockwood
President, Oregon National Guard Association
Executive Officer, Oregon Military Department
State Judge Advocate, Oregon National Guard

I am testifying in the dual capacity as the Executive Officer of the Military Department of the State of Oregon, my full-time position, and as President of the Oregon National Guard Association, an Oregon non-profit corporation whose membership includes all Oregon National Guard officers and warrant officers who are in the active National Guard, and inactive and retired officers and warrant officers of the National Guard.

The Oregon National Guard is very much a part of the "Total Force" of the United States Armed Forces. The 41st Infantry Brigade serves as a "roundout" Brigade to the Army's 7th Division located at Fort Ord, California. On mobilization, this unit would report directly to Fort Ord for deployment with the 7th Division. Other Army Guard units have similar mobilization responsibilities. On the Air Guard side, we have a continuous air defense mission as part of the 25th NORAD mission. The Oregon Air National Guard's 142nd Fighter Interceptor Group, based in Portland, Oregon, maintains four F-4 aircraft on constant alert. Two aircraft are on alert in Portland and two at Kingsley Field, Klamath Falls, Oregon. The Air National Guard has other units which also are an integral part of the Air Force's mission for defense of the United States and for support of the Air Force wherever it may deploy.

This background information is provided to show that the National Guard, both Army and Air, is a part of the front-line defense of this nation and represents approximately 50 percent or more of the combat strengths of the Army and Air Force.

In order to recruit and retain qualified personnel in the Oregon National Guard, incentives are necessary. The first priority for incentives is a home mortgage program for Guard members. At the present time, legislation is being drafted to include National Guard as eligible persons under the Oregon Department of Veterans' Affairs Home Mortgage program. Legislation was introduced in the 1981 Session but was not moved from committee due to the problems concerning the definition of "Veteran" under the Temporary and Proposed Single Family Mortgage Subsidy Bond Regulations. These regulations, at page 77 (Section 6a.103A-3(c)), defines Veteran as follows: "(c) Veteran. The term "veteran" shall have the same meaning as in 38 USC 101(2), that is, a person who served in the active military, naval, or air service and who was discharged or released therefrom under conditions other than dishonorable."

Title 38 USC does not define active service but it does define active duty. Subsection (21) of 38 USC 101 defines active duty as: "(A) Full-time duty in the Armed Forces, other than active duty for training, ..."

Active duty for training is defined in Section (22), 38 USC 101, as follows: "(22) The term 'active duty' for training means ... (C) in the case of members of the National Guard or Air National Guard of any State, full-time duty under Sections 316, 502, 503, 504, or 505 of Title 32, or the prior corresponding provisions of law; and (D) authorized travel to or from such duty ..."

National Guard members, both Army and Air, who do not have prior military service are required to perform "ADT" active duty for training for periods of approximately 120 days or more. This period includes basic training and Advanced Individual Training. This training is under the provisions of 10 USC 672(d). It appears that neither 38 USC 101 subsection (21) "active duty" or subsection (22) "active duty for training" includes this 10 USC 672(d) service. Section 672 of Title 10 USC is termed active duty.

It is my opinion, based upon the definitions of "veteran" as set forth in 38 USC 101, that National Guard members who do not have prior active military service, would not be considered as "veterans."

It should be noted that National Guard members who are permanently disabled or killed in the line of duty and while serving under 32 USC 502, 503, 504 and 505 and under 10 USC 672(d) are eligible for Veterans' Administration benefits under Title 38 USC. This means that for some purposes this service is qualifying for veterans status, but for purposes of the Omnibus Reconciliation Act of 1980, it is in doubt.

The possible solution to the problem of the restrictive definition of "veteran" are as follows:

1. Totally exempt State Veteran Mortgage Programs from the Omnibus Reconciliation Act of 1980.

2. Allow each State Department of Veterans' Affairs to define qualifying "veteran."

3. Amend the definition of "veteran" to include service under the provisions of 10 USC 672(d), or in the alternative to include language which broadens military service to include full-time duty and full-time active duty for training in the Armed Forces.

4. Amend 38 USC 101 subsection (21) by deleting the words "other than active duty for training."

I sincerely appreciate the opportunity to present this testimony. The clarification and/or expansion of the definition of "veteran" to include National Guard members who have performed service under 10 USC 672(d) will allow for providing Oregon Department of Veterans' Affairs home mortgage loans to Oregon National Guard members and thereby greatly enhance our ability to recruit and retain qualified personnel.

Respectfully submitted,

Gary E. Lockwood
GARY E. LOCKWOOD
COL, ORARNG
Executive Officer

STATEMENT BY

NATIONAL LUMBER AND BUILDING MATERIAL DEALERS ASSOCIATION

ON

S. 1348

PROPOSED AMENDMENTS TO
INTERNAL REVENUE CODE OF 1954
CLARIFYING REQUIREMENTS OF
MORTGAGE SUBSIDY BOND PROGRAM

BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE

OCTOBER 16, 1981

The National Lumber and Building Material Dealers Association (NLBMDA) appreciates the opportunity to present our views on S. 1348, the proposed amendments to the Internal Revenue Code of 1954 and the Mortgage Subsidy Bond Act of 1980 as included in the Omnibus Reconciliation Act of 1980. NLBMDA congratulates the subcommittee for its hearings and concern on this significant issue. NLBMDA believes it is important for Congress to consider immediate legislative remedies to the stalemate conditions that exist in the tax-exempt mortgage bond program. A workable and fair tax-exempt mortgage revenue bond program is essential to all segments of the shelter industry, especially during the times of reduced construction activity and high costs of housing credit which our nation is currently enduring.

NLBMDA is a national trade association, consisting of twenty-five affiliated federated regional, state and metropolitan associations of retail lumber and building material dealers. These dealers, totalling some 15,000 in all parts of the nation, supply building materials to the home building, general contracting, remodeling and building maintenance inudstries, and to the general public. The retail lumber and building material industry represents in annual sales a $25 billion business and is an essential segment of the American home building industry.

However, present conditions are far from satisfactory. A recent poll taken among our 15,000 member dealers indicated that our normal material business sales activity is down 20 percent compared to 1978 and the level of employment in our retail stores has been reduced by 15 percent. Fully 61 percent of our dealers are experiencing reduced activity, especially in the field of contractor (home builder) activity -- once the "bread and butter" segment of NLBMDA members' retail operations.

A major negative contributing factor to the effects of inflation, high supply and labor costs, and record level interest rates, both mortgage and commercial rates, to our lumber and building material dealers is the fact that at the present time there is no tax-exempt mortgage bond program. Before 1980, during economic downturns, the mortgage bond program provided a considerable construction "back stop" for our shelter industry. This alternative financing method for new home construction represented a $10 billion a year program, certainly a not insignificant source of capital for the battered housing industry. As a result of the recent law, the Mortgage Subsidy Bond Act of 1980, the utilization of the mortgage bond program to serve as an important financing option is no longer available. With this significance of the mortgage bond program to the housing construction in mind, it is easy to understand that no other piece of legislation before Congress this session would have a more immediate and beneficial effect on the currently depressed home building industry than approval of S. 1348.

The Mortgage Subsidy Bond Act, as included in the Omnibus Reconciliation Act of 1980, legislated numerous restrictions on the mortgage bond program. Perhaps the most restrictive aspect in the new law is the sunset provision which ends the tax-exempt feature for the qualified single-family mortgage bond programs on December 31, 1983. During Congress' deliberations on the issue, NLBMDA supported the general characteristic of the 1980 law which targeted the tax-exempt subsidy feature of these bonds to low and moderate income Americans and to certain designated areas. However, NLBMDA believes that several provisions of the new mortgage bond law unintentionally exceeded Congress' original purpose on the issue and, in fact, the resulting structure of the new law made the mortgage bond program unworkable. The structural problems with the 1980 Act were not alleviated when several months after the legislation had been approved by the 96th Congress, the Treasury Department issued mortgage revenue bond regulations. The Treasury Department regulations did not solve the major "workability" problems which effectively block the issuance of new bonds. Therefore, since the Congressional approval of the Mortgage Bond Subsidy Act of 1980, no new mortgage bonds issuance have been issued.

The present unworkable character of the mortgage bond program is especially onerous to single-family home financing (which is the type of housing that NLBMDA is primarily concerned about today during these hearings) because the authority to utilize mortgage revenue bonds for single-family financing terminates at the end of calendar year 1983. By not having a usable single-family mortgage bond program in place for calendar year 1981, fully one-third of the available legislative authority is lost.

Clearly, it was not the intent of Congress to end the tax-exempt mortgage bond program for single-family housing before December of 1983. The deliberations and legislative activity on this issue were aimed toward targeting the benefits, and restricting the use, but never to terminate the entire program. With this salient point in mind, the legislative proposal before us today, S. 1348, takes on an emergency characteristic and entails mostly technical changes to remove the unnecessary regulations and inconsistencies that have effectively stopped the use of these bonds. NLBMDA heartily endorses the legislation and makes the following single-family recommendations which ammend these no-go provisions in the existing 1980 Act.

1. 95 PERCENT TEST - Present law requires that at least 95 percent of proceeds of the bonds be devoted to mortgages which meet all of the numerous "targeting" requirements or the entire mortgage bond issue will become taxable. The regulations require that for each mortgage financed from the bond issue which fails to meet these requirements, the portion of the proceeds represented by each such mortgage will be cumulatively measured against the five percent allowable error margin. As the law currently reads, errors associated with each mortgage financed from the issue, even if corrected, still apply to the overall five percent error margin. This 95 percent test is the primary obstacle for a workable bond program because under these circumstances bond counsels are unable to

render unqualified tax opinions.

NLBMDA endorses this section of S. 1348 which eliminates the 95 percent rule and in its place requires a bond issuer to act in good faith in attempting to meet all existing requirements before the mortgages are executed. Any failure to meet the targeting requirements should be allowed to be corrected within a reasonable period after such failure is first discovered. At the very least, the 95 percent requirement should be ammended to allow for this correction so that the requirement is not cumulative.

2. ARBITRAGE - In the Mortgage Subsidy Bond Act of 1980, Congress addressed the issue of the "spread" between the yield on the bond and the yield on the obligation acquired with the proceeds. Current law limits this spread to one percent and effectively created a new class of tax-exempt obligations which have been singled out for discriminatory arbitrage treatment. Housing bond issuers must comply with this restrictive and complex one percent arbitrage rule, and yet it does not apply to any other tax-exempt issuers. As a result, the only issuers who can afford this restrictive one percent limitation are those who can commit substantial outside funds to support the mortgage bond issue. This is clearly inequitable for mortgage bond issuing agencies which do not have substantial reserves or who are relatively new to mortgage bond activity.

The needed percentage increase over the currently restrictive one percent requirement depends largely upon the condition of the issuing agency. There is unsure evidence whether, for example, an increase to a 1.25 spread is large enough to permit small or newly established agencies to utilize the mortgage bond program. Because of this uncertainty, NLBMDA concurs with the language in S. 1348 and recommends, at a minimum, an increase to 1.50 percentage yield from 1 percent for issuers to comply with the program. NLBMDA further recommends that Congress carefully monitor whether this 1.50 percentage yield is, indeed, too restrictive for smaller agencies and that further increases of the percentage yield if needed, be permitted at a later date. We believe that our recommendations for an increase to 1.50 percentage spread is the absolute minimum increase to make the program workable once again on a nationwide basis.

3. RESERVES - Current provisions of the Mortgage Subsidy Bond Act of 1980 now place an issuer of these bonds in a position where it may be forced to liquidate investments at a substantial loss even if this would result in a default on the bonds. This could occur even when the issuer has available substantial amounts of investment earnings. NLBMDA supports the provision in S. 1348 which would permit the issuer to use earnings to offset the loss or to continue to hold the investment until it may be liquidated without a net loss.

4. PRIOR RESIDENCY REQUIREMENTS - Current law limits participation in a tax-exempt mortgage bond program to persons who have not owned a principal residence within the past three years in non-targeted areas. NLBMDA believes this requirement to be overly restrictive for those persons who live in sub-standard housing or where the owner is displaced from his prior residence by governmental action or natural calamity. Therefore, NLBMDA recommends that the prior residency requirements be ammended to permit previous owners who fall into these categories of sub-standard housing, federal displacement and natural disaster, be permitted to participate in the mortgage bond program, as proposed in the legislation S. 1348.

5. REGISTRATION REQUIREMENTS - Unlike other tax-exempt bond issues, Congress required housing bonds to be registered in an effort to further monitor their use. However, the net effect of this requirement simply adds further administrative costs and burdens while considerably hampering the housing programs designed to meet lower income families. This registration requirement acts in a discriminatory fashion and until such time as Congress decides to register all municipal bonds, the registration burden should be eliminated. As proposed in S. 1348, NLBMDA recommends the elimination of all registration requirements for mortgage revenue bonds.

The inactive condition of the mortgage revenue bond program can be immediately remedied by quick Congressional approval of S. 1348 as introduced by Senator Sasser of Tennessee. This legislation is non-controversial and does not make substantive changes to existing law. Its technical corrections nature does not change the original purpose of the 1980 mortgage bond legislation passed by Congress.

Swift approval of S. 1348 is of the utmost importance to our lumber and building material dealers. The legislation is urgently needed because of record high interest rates which have made it impossible for the average American to afford a new home using available conventional mortgages and because the current economic realities which are faced by the entire shelter industry. Unless some immediate relief, as formalized in S. 1348 is enacted, many of these type of businesses will simply be unable to survive today's economic conditions. The long term effect of a substantial number of shelter industry failures would prove disastrous for the home buying public and to the American economy as a whole.

Although passage by Congress of the proposed amendments to the mortgage bond program would not solve all of the problems associated in the home construction industry today, the enactment of S. 1348 would be a significant step in the right direction and would demonstrate that Congress and the President are indeed concerned with the question, "Where will our children live?"

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NOTARY PUBLIC
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October 14, 1981

Senator Robert Packwood
Chairman Subcommittee on Taxation
and Debt Management
Room 2221
Dirksen Senate Office Building
Washington, D.C.

Dear Senator:

I have been advised that on October 16, 1981, your committee will consider SB #608, SB #1479 and SB #1580 which will amend the Internal Revenue Code to permit the expenses and fees paid to an adoption agency to be deducted as an itemized expense on an individual tax return, form 1040.

As legal counsel for Adopted Couples Together, Inc., I would like to see some deduction permitted. It would seem to me that the expense of an adoption is equivalent to the expense of a birth and to the extent that the expense of a birth is deductible, there exists a discrimination against an adoption.

Equity should permit the treatment of a fee paid an agency, and in particular where some of the fee is used to support the natural mother during her pregnancy, to be deducted in the same limitations as the medical expenses that would be incurred in this situation.

While some of the above number bills go further in their economic impact, our organization would be satisfied with the minimum I have stated above. It would appear to me that the impact of this minimum proposal on government revenues would be very small.

Please read my letter into the record at the hearing. Thank you for your cooperation in this matter.

Cordially,

Robert E. Ahrens
Robert E. Ahrens

REA/jbd

cc: Senator Russell B. Long

TESTIMONY OF THE HONORABLE BILL GREEN, BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE UNITED STATES SENATE - OCTOBER 16, 1981

My name is Bill Green. I am gratified to meet with you and to have an opportunity to testify on S. 1656. As many of you know, I have long been involved in the housing field and interested in its success and its problems: originally as a staffer and then an Assemblyman in the New York State legislature, then as a Regional Administrator of the Department of Housing and Urban Development, and since entering the House of Representatives, as a member of committees which are involved in the housing area.

I want to express my strong support for responsible initiatives to encourage the increased production of multifamily housing with the use of tax exempt financing. I believe that the continued use of tax exempt obligations to provide funds with which to make mortgage loans for multifamily rental projects is crucial to our continuing ability to provide decent and affordable housing to low and moderate income individuals in this country.

The Need for More Rental Housing

In a sense, I speak to a quite simple proposition. For a number of years, the primary catalyst for the production of assisted multifamily housing has been the Section 8 program. What we have seen, of course, and the reasons have been documented at length elsewhere, including a number of Congressional hearings, is a steady reduction in the number of Section 8 units requested in the budget. In recent years the numbers requested have decreased and the numbers approved have been even lower.

The bottom line certainly does not change the picture. As you know, the Carter budget request for fiscal year 1982 was to fund 260,000 Section 8 units; the revised Administration request was for 175,000 units; the reconciliation process resulted in 153,000 units. We are obviously seeing the extinction of Section 8 as a housing production vehicle. Few knowledgeable in the area envision the program's continuation beyond 1983 and it is likely that we will see no new and substantial rehabilitation Section 8 units funded after fiscal year 1982. My point is, however, that we are not dealing with 1983. For the present, multifamily rental housing is almost entirely dependent upon Section 8 assistance. My city and my constituents need workable solutions now. The situation has changed considerably even since the passage of the Mortgage Subsidy Bond Tax Act of 1980 (the "Act").

I do not believe it was the intent of that legislation to choke off multifamily production altogether and we should not and cannot allow this to occur. Before I pursue these points further, I think we must examine the real issue here -- the need for multifamily housing production. I think there is little dispute that under current laws production has not occurred at even minimally reasonable levels.

Because Anthony Gliedman, Commissioner of the Department of Housing Preservation and Development of the City of New York and Chairman of the New York City Housing Development Corporation has submitted a statement which addresses, at least briefly, the needs of New York City, I would like to discuss the national problems affecting multifamily rental housing.

Perhaps the first major analysis of what has come to be called the rental crisis appeared in a report of the General Accounting Office in November, 1979. It laid out the following picture, to which I have occasionally added some current figures:

- Slightly over a third of American families live in rental housing.
- Production of new rental housing has decreased sharply, and most increases in the late seventies reflect the increased numbers of federally subsidized units.
- A national vacancy rate of about five percent barely meets the level permitting population mobility; vacancy rates are much lower in certain areas, and are at about half that percentage for larger units needed by families. (Recent figures from U.S. Housing Markets/Advance Mortgage Corp. indicate between the first half of 1980 and the first half of 1981 rental vacancies declined by a further 160,000 units.)
- One third of renters in 1979 paid more than 35% of their income for housing costs.
- Sharply rising home costs and interest rates not only

preclude home ownership for moderate income renters, but, with the average median sales price for an existing home now over $67,500, numerous "plan to buy" Americans find themselves instead in frustrated competition for adequate and affordable rental housing.

- The report concludes "Our Nation's rental housing market has reached a crisis stage creating particularly bleak prospects for low income renters".

The dimensions of the GAO report are worth noting, it seems, because there was a rental crisis in 1979. Current literature on the subject from certain circles might suggest that this is not the case today, and that the GAO report may have overstated its case. Some have suggested that the housing shortage problem is a spotty one, that in many cases existing housing can meet national rental demand, and that what is awry is simply our sense of expectation: people will have to learn to pay more for less and enjoy it. I am here today to support the multifamily provisions of S. 1656 as a first step because I am unconvinced that the situation is simply one of perceptions or that the fact situation has improved since 1979.

Indeed, Census Bureau figures show a recent half percent drop in the rental vacancy rate. The most recent housing surveys estimate only 75,000 unsubsidized rental starts this year, the lowest total since World War II. And a full third of that activity is expected to be in Houston-Dallas-Fort Worth. Even if predicted subsidized starts raise the total rental unit production to 250,000, which is doubtful in light of current interest rates and budget restrictions, that figure still represents the lowest production level since 1958. It does not even cover the loss of rental housing stock those same experts estimate occurs annually through fire, abandonment and demolition.

Obviously, I do not believe the pressures on the rental housing market have conveniently vanished in the last two years. For this reason I would urge you support those changes proposed in S. 1656 and also act to effect certain broader changes such as reduction of the 20% occupancy requirement for Section 8 eligible tenants to 10%.

Problems with Current Law

Over the past year we have seen issuers struggling to structure housing bonds in a manner which will satisfy the requirements of the Act and to continue to provide housing for low and moderate income individuals in their localities. We have seen their frustration as they attempt to structure financings using the Section 8 moderate rehabilitation program and their inability to resolve the dilemma posed by a 20 year occupancy requirement and the 15 year term of the Section 8 moderate rehabilitation contracts. We have also watched in frustration as the moderate rehabilitation Section 8 program has gone largely unused since financing at feasible rates has not been available.

S. 1656 represents an opportunity for us to remedy three of the most severe practical difficulties caused by the Act. I have reviewed Commissioner Gliedman's statement and I am in full agreement with his description of the constraints posed by the Act and his explanation as to how S. 1656 will help resolve these difficulties, together with his additional suggestions for modification of the Act. As a result, I will touch only briefly on these issues.

I believe the technical changes set forth in S. 1656 which I will discuss in more detail later in this testimony will assist in financing and producing a moderate amount of multifamily rental housing by taking advantage of those funds currently available, particularly those for the Section 8 moderate rehabilitation program. These technical multifamily provisions along with a provision which recognizes housing cooperatives as rental housing under Section 103(b)(4)(A) must be enacted without delay.

We must recognize, however, that these technical changes do not address the larger problem. The simple fact is that the current 20% low income occupancy requirement is overly restrictive in its present form and must be relaxed.

The most severe constraints under the Act stem from the requirement that at least 20% (15% in targeted areas) of the units in any property financed with tax exempt bonds would have to be occupied by Section 8 qualified tenants for 20 years. Obviously, this prevents the tax exempt financing of projects which can be developed and operated without the need for subsidies under Section 8 or without assistance under state and local programs. This reduces production of much-needed housing units. Since this occupancy requirement can, as a practical matter, be satisfied only through the execution of 20 year Section 8 contracts for projects financed with housing bonds, this has also resulted in an increased competition for Section 8 subsidies. Thus in many cases, applications for Section 8 subsidies are being submitted for projects which do not need Section 8 assistance in order to be developed. A diversion of Section 8 units away from certain areas and projects in which they are most desperately needed is the end result.

For fiscal 1982 we have reduced Section 8 budget authority for the new construction and substantial rehabilitation programs substantially. We expect that the Administration will propose even fewer units for fiscal 1983 or the total elimination of the Section 8 new construction and substantial rehabilitiation programs. The reduction in the levels of Section 8 assistance will increase the competition for available Section 8 units, increase the potential misallocation of these scarce units and eventually, if Section 8 assistance is eliminated for new construction and substantial rehabilitation, the result will be a virtual cessation of tax exempt financing of multifamily housing. We cannot permit this to occur.

S. 1656 deals directly with one aspect of the occupancy requirement, the term of the occupancy requirement. Under S. 1656 the term of the occupancy requirement would be the longer of ten years, one-half the term of the obligations or the duration of Section 8 assistance for the project. This formula presents an excellent start in the right direction, as it would permit the use of the Section 8 moderate rehabilitation, property disposition and loan management programs in conjunction with tax exempt financing and effectively incorporate the 20 year transition rule into the Act itself. In considering the term of the occupancy requirement last year, we focused upon 40 year housing bonds and 20 year Section 8 contracts which would be available for only one-half the term of such obligations. This approach I think properly recognizes that both the Section 8 contracts and the term of the bonds may be for shorter periods; the term of the occupancy requirement as modified by S. 1656 would take these variations into account and allow issuers to adjust their financings in light of the available subsidies and market requirements. The only change which may be necessary to this rule is that the occupancy requirement should not be required to commence on the date of first occupancy. This is a technical problem resulting principally from the fact that some rehabilitation will occur with tenants in place. This point can be worked out with staff.

It makes sense to consider a change in the 20% level for low and moderate income tenancy this year. We cannot ignore the fact that Section 8 assistance for new construction and substantial rehabilitation will not be available in the future. We cannot wait until a year or two passes without Section 8 to face the problem of our rental housing needs. We must consider other ways in which to assume that some of the benefits of tax exempt bonds will go to low income tenants while at the same time assuring a viable production vehicle. As suggested by Commissioner Gliedman in his submitted statement, one way to do this is to change the project-by-project occupancy requirement to an aggregate requirement applied to all projects financed by the issuer. This would allow issuers to continue to promote the production of urgently needed housing units as Section 8 budget authority is further reduced or eliminated.

This kind of approach could facilitate the implementation of the housing voucher approach advocated by this Administration and permit the use of tax exempt financing for housing which is assisted by other federal, state or local assistance programs.

While S. 1656 does not address the issue of how cooperative project mortgages are to be treated for the purposes of tax exempt financing, it would be desirable to take this opportunity to resolve the issue. I believe that cooperative housing should be treated as multifamily rental housing for the purposes of Section 103(b)(4)(A). Although in some respects cooperative housing can be viewed as owner occupied housing, I believe that it bears a greater similarity to multifamily rental housing and should be treated as such under the Act. Cooperative housing is very important in my district and in general offers housing opportunities to low and moderate income individuals in New York which are not afforded through single family housing.

Pressing arguments both nationally and from a more local perspective exist for the narrow, technical modifications in the Act which are embodied in S. 1656. I would reiterate one earlier point. New York City and New York State, like many other jurisdictions, have consistently attempted to meet their housing needs effectively and responsibly. Federal assistance and the absence of federally imposed restrictions permit the states and localities to do a better job. Currently cities and states are stymied, in part because of restrictions in §103. Without some of these changes - and S. 1656 provides an appropriate vehicle - none of us can address the inadequacy of the rental housing supply for those - often low income, elderly minority or female head of household - families who have no choice but the rental market or who have no desire to undertake the burden of homeownership.

Thank you for providing me with the opportunity to provide my views and perspectives on this important subject. I would be course be pleased to respond to any questions.

ACCL

American Citizens Concerned for Life, Inc.

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STATEMENT OF SUPPORT FOR S.1479 AND S.608

ADOPTION LEGISLATION HEARING
OF
OCTOBER 16, 1981

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE OF THE
UNITED STATES SENATE

American Citizens Concerned for Life welcomes the opportunity to state its support for legislation which would improve the lives of many children by making changes in the tax code.

Our national association is dedicated to the promotion of respect for human life and optimum human development. We have long supported adoption as a positive alternative to abortion and as a responsible approach to building families and improving lives.

There are several changes in the tax code now under consideration, and we wish to express support for the following:

S.608

We strongly endorse a provision making expenses for adoption deductible when arranged through licensed public or private, non-profit adoption agencies. We believe this not only encourages adoption, but encourages adoption which is accountable, licensed and professionally sound. We thank Senator Baucus for his leadership and initiative in introducing this legislation.

S.1479

We urge consideration of inclusion as part of any tax bills for enactment into law three provisions of S.1479.

1) allow families that adopt to claim the costs of an adoption arranged through a licensed public or private, non-profit adoption agency as tax deductible (identical to S.608). Several states have already led the way in this area, ACCL's home-base state of Minnesota being one of them. Minnesota's law -- since 1978 -- has been cost-effective to the state and beneficial to the taxpayers who have built their families through adoption. By requiring adoptions to be arranged through a licensed agency, the best interests of the child have been placed over any other factor. (Exception is made to allow biological parents to place children for adoption with a step-parent or close

relative directly, with only a legal court procedure required.) We recognize that the emotional aspect of the adoption process must be complemented by an appreciation for the objective, legal basis of adoption;

2) exclude from the income of an employee any fringe benefits received from an employer's adoption expenses plan;

3) treat the employer contribution to adoption expense plans as an ordinary and necessary business expense.

Regarding points 2 and 3, we commend the major corporations who have begun programs to benefit adoptive families, but we feel that the adoption benefits should be treated as non-taxable income. The real benefit to employees is substantially reduced through taxation. For the employers who have responded to employees' needs in the adoption area, we ask that, for tax purposes, their contributions to adoption expense plans be treated as an ordinary and necessary expense. It is our hope that more and more employers will respond with adoption programs when given such incentives.

We thank Senator Metzenbaum for offering such positive features in his proposal to amend the tax code.

We wish to commend all of the members of Congress who have worked for the enactment of improved adoption laws, and we thank Senator Packwood and the other members of the subcommittee for their time and interest in this important area.

Attachment: ACCL Statement of Purpose

ACCL

American Citizens Concerned for Life, Inc.

Administrative Office
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ACCL--PROTECTING AND IMPROVING LIFE

If you are concerned that life in America today is not equally protected for all...if you want to do something effective about improving respect for life and the quality of life in our country... Welcome to ACCL!

ACCL is an association of the kind of people who would once again wed freedoms and responsibilities, the freedoms all human beings deserve with the responsibilities they require. Our membership is drawn from the 50 United States and represents a broad-based cross-section of religious faiths, occupations and cultural backgrounds. What we have most in common is a deep respect for the value of human life and a determination to influence public attitudes and policy so that all human beings will be protected and have the opportunity to achieve their potential.

Legislation

The ACCL legislative program is varied and extensive. Legislation which affects vulnerable members of society is of special interest to the organization. Our current research and lobbying activity focuses on four areas: supportive services for pregnant women, particularly adolescents; educational programs to prevent adolescent pregnancy and increase responsible sexuality; health needs and rights of children, born and unborn; and family challenges, especially concerning children and the aged.

ACCL enjoys an excellent reputation with public officials as a responsible pro-life group demonstrating maturity in the pursuit of its goals and producing comprehensive issue analyses. We have been called upon as resource persons and to submit testimonies to Congressional committees. Recently ACCL's participation was requested by the White House Conference on Families, the Select Panel for the Promotion of Child Health and the Population Advisory Panel of the Office of Technology Assessment of the Congress.

The ACCL approach recognizes that there are many people of good will who differ with our abortion position or who have not yet been awakened to the seriousness and meaning of the present situation.

Our program emphasizes persuasion, education and action which demonstrates that people are important and that positive solutions to human problems are possible if we will work together. Respecting differences, the program concentrates on areas where common concerns and interests exist and where concrete progress can be made toward saving lives and influencing attitudes. Recent passage of the Adolescent Pregnancy Act, providing help to needy pregnant adolescents and their children, resulted when ACCL saw the problem and the opportunity and worked with Congress, the Administration and groups around the country until success was achieved.

Education

The purpose of ACCL's educational fund and program is to inform people about the life issues and the importance of meeting human needs, awakening those who have not yet faced the destruction of human life and challenging those willing to help secure care and protection of those in need.

Materials developed by the association are used across the country and include a slide/tape presentation on the "Doublespeak" of abortion; a manual, "Counseling the Individual Experiencing a Troubled Pregnancy"; and numerous pamphlets and books on pro-life work and issues.

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WILLIAM J. LEHRFELD
LEONARD J. HENZKE, JR.

October 26, 1981

The Honorable Charles E. Grassley
Chairman
Subcommittee on Oversight of the
Internal Revenue Service
Senate Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Attn: Harry Graham, Esquire
Counsel, Senate Finance Committee

Re: Attorneys' Fees Reimbursement
Hearing of October 19, 1981

Dear Senator Grassley:

On October 17, 1981, I testified on behalf of the Shriners Hospitals for Crippled Children, respecting recovery of attorneys' fees in tax litigation. At the conclusion of my prepared testimony, you asked whether providing attorneys fees reimbursement to the Shriners Hospitals, to pay for their attorneys' service in litigation respecting the deductibility of charitable gifts and bequests, would greatly expand the classes of litigants eligible for fee reimbursement, so that eventually even intervenors and amici curiae would logically qualify for such fee awards. After the hearing, Committee Counsel Harry Graham followed up your question, asking if special statutory provisions to allow awards to charitable donees are necessary, or whether awards to such charities would be allowable in any event under the current provisions of the Equal Access to Justice Act and the proposed S. 752 and S. 1673. This letter is submitted in response to the request of Mr. Graham that I address this subject in greater detail in writing. I would appreciate your incorporating the letter as part of the written record, as a supplement to the Shriners Hospitals' written statement.

As explained in our original statement, the Shriners Hospitals is totally dependent on charitable gifts and bequests for its support. It thus frequently retains tax counsel to assist counsel for donors or estates in litigation of tax cases involving the deductibility of charitable donations or bequests to the Shriners Hospitals. While as a formal matter the attorneys retained by Shriners Hospitals are associated as co-counsel for the donor or estate, such attorneys receive their fees and expenses on a current basis from Shriners Hospitals, regardless of the outcome of the litigation. In many cases, Shriners Hospitals also pays all or part of the fees of the local counsel for the donor or estate.

We think that in such circumstances, the Equal Access to Justice Act and the pending bills (S. 752 and S. 1673) would permit the Shriners Hospitals to receive an appropriate share of an attorneys fee award to a donor or estate when the Shriners Hospitals had arranged and paid for such direct litigation support. However, the matter is not free from all doubt, as will be discussed below; a provision in the statute or an explanation in the committee reports will clarify the issue and avoid needless litigation.

On its face, S. 1673 plainly would appear to allow recovery of attorneys fees and other costs expended by or on behalf of attorneys for the Shriners Hospitals, when they serve as co-counsel for a taxpayer-donor or taxpayer-estate in litigation respecting the deductibility of a gift or bequest. Proposed Section 7430(a) would provide that--

> * * * In the case of any civil action or proceeding which is * * * brought by or against the United States for the determination, collection, or refund of any tax, interest, or penalty under this title, * * * the prevailing party may be awarded a judgment for reasonable court costs incurred in such action or proceeding.

Proposed Section 7430(c)(2) would provide that the term "prevailing party" means "any party to any action or proceeding described in subsection (a)" who meets certain described tests for "prevailing." Proposed Section 7430(c) would define the "reasonable court costs" incurred by the prevailing party and recoverable under Section

7430(a) to include "reasonable fees paid or incurred for the services of attorneys." The comparable provisions of the Equal Access to Justice Act, 5 U.S.C. §§504(b) and (d)(2)(B) are similar except that certain net asset value limitations are placed on prevailing parties eligible for attorneys fees.

As noted above, attorneys for the Shriners Hospitals are frequently co-counsel to counsel for the taxpayer-donor or taxpayer-estate in litigation respecting the deductibility of the taxpayer's charitable contribution. When attorneys fees are paid to or incurred by such co-counsel, by authorization of and on behalf of the taxpayer, such fees are "paid or incurred for the services of attorneys" in such action or proceeding, and should be eligible for reimbursement if the taxpayer prevails. See, e.g., Aames Automatic Transmissions v. Taylor, 82 F.R.D. 405, 409 (E.D. Pa. 1979); In re THC Financial Corp. Litigation, 86 F.R.D. 721, 740 (D. Haw. 1980); cf. Brennan v. United Steelworkers of America, Etc., 554 F.2d 586, 608 (3rd Cir. 1977), cert. denied, 435 U.S. 977 (1978).

However, a recent decision of the D.C. Circuit, Nat. Treasury Emp. U. v. U.S. Dept. of Treasury, 656 F.2d 848 (1981), might be interpreted in such a way by the Government so as to cast doubt on the right of the Shriners Hospitals to reimbursement for its attorneys and other costs incurred on behalf of the taxpayer. There, a union member sued I.R.S. for violation of the Privacy Act. Attorneys for the member's union prosecuted the suit in the member's name, pursuant to a group legal services agreement. The attorneys received only their regular union salaries for this work. After the member prevailed, the union sought recovery of attorneys fees at standard rates. The court denied any award in excess of the out-of-pocket expenses of the union, on the ground that to award the union the full reasonable fees would involve it in the unauthorized practice of law.

We think that the legal assistance programs offered by charitable donees to contributors-taxpayers in tax litigation regarding charitable deductions is different from the circumstances in the D.C. Circuit case. In particular, most exempt organiztions employ outside counsel to perform such legal services, and normally the fees and other expenses actually incurred by or paid to the charities' attorneys will constitute the allowable reasonable fees under the attorneys' fees statute. In particular, unlike in the D.C. Circuit case, the Shriners Hospitals would certainly not make any profit on any fee reimbursement it received.

Nonetheless, this area of the law is still in its formative state, and the Executive Branch traditionally interprets tax statutes of this kind quite restrictively.*/ We believe that tax cases should not be burdened with this issue where an exempt organization has properly participated in the contribution deduction litigation, with the contributor-taxpayer's authorization or consent, in order to protect the tax deduction and thus preserve the full gift for the charitable donee's benefit.

The Supreme Court in Bob Jones University v. Simon, 416 U.S. 725 (1974), and Congress in I.R.C. Section 728, have recognized that charities have a unique and vital interest in the deductibility of charitable contributions by their supporters. In these times when charities are being asked to shoulder an increasing share of the Nation's social problems, and recent tax statutes have had the unintended effect of decreasing financial support for charities, Congress has a responsibility to ensure that charities are not barred by hypertechnical interpretations of the attorneys fees statute from receiving fee reimbursements when they protect their contribution support by providing legal assistance to their supporters.

It may be that this clarification in the law can be effectively accomplished by a statement in the committee reports that charitable donees which furnish attorneys services to their supporters in charitable contribution deduction litigation are eligible to receive fee reimbursement. Of course, if the Equal Access to Justice Act is retained for District Court and Court of Claims litigation, it is not only necessary to clarify the law as to the right of the charitable donee to fee reimbursement, but in addition the asset-size limitation in 5 U.S.C. §504(d)(2)(B) must be removed; our written statement contains suggested language for such a statutory amendment.

_/ For example, the Government's policy has been to narrowly limit the class of persons eligible to bring a suit for refund. See, e.g., McCure v. United States, 75-2 U.S.T.C. par. 9657 (C.D. Calif. 1975); Sunset Memorial Ass'n. v. United States, 74-2 U.S.T.C., par. 9808 (D.N.M., 1974); Agron v. Illinois Bell Tel. Co., 325 F. Supp. 487 (N.D. Ill. 1970), aff'd on another ground, 449 F.2d 906 (7th Cir. 1971).

The Honorable Charles E. Grassley
October 26, 1981
Page Five

Thank you for this opportunity to supplement our prior written statement. Please let us know if further information is needed.

Sincerely yours,

Leonard J. Henzke, Jr.
Tax Counsel for
Shriners Hospitals for
Crippled Children

LJH/bcc

Good Morning, Mr. Chairman and members of the Subcommittee:

My name is Robert Austin and I am Chairman of the Louisiana Housing Finance Agency. I thank the Subcommittee for allowing me to testify regarding S. 1348 and S. 1656, bills to amend the Mortgage Subsidy Bond Tax Act.

I would like to begin by briefly describing the Louisiana Housing Finance Agency. The Agency was created in 1981 by an act of the Louisiana legislature; its purpose is to assist low and moderate income persons obtain safe, sanitary and decent housing. We have not yet begun to assist families purchase their homes because of the legislative problem I am here to address. We had planned to utilize single family mortgage revenue bonds in our efforts. By taking advantage of lower tax-exempt rates, states and localities can provide mortgage money to home purchasers at interest rates closer to what most homebuyers can afford to pay.

Background on the Problem

Unfortunately, we have been unable to sell single-family mortgage revenue bonds and therefore have not provided homeowners with lower interest rate mortgages. This is especially unfortunate given the dismal condition of the housing industry. I need not remind members of this Subcommittee of the problems plaguing the housing industry and potential homebuyers and sellers.

We in Louisiana and in similar housing agencies across the country have been prevented by the Mortgage Subsidy Bond Tax Act of 1980 from doing our job in helping to provide housing at reasonable costs. That Act, which was designed to target mortgage revenue bonds, has virtually killed state and local mortgage revenue bond programs instead.

Our Louisiana agency, and other state and local housing agencies, accept the policy objectives that Congress had in mind in passing that law:

- To set a cap on total state mortgage revenue bond activity;
- To target mortgage bond programs to first time homeowners; and
- To target aid to moderate cost housing.

Unfortunately, the Mortgage Subsidy Bond Tax Act goes beyond these policy objectives and also includes certain provisions extraneous to the policy objectives which have virtually shut down mortgage revenue bond programs throughout the country.

In the ten months since the Act became effective, state and local agencies have tried to make it work. But, the technical provisions of the Act--expecially those related to arbitrage and the so-called ninety-five percent test--have proved insurmountable. Since the Act has been in effect, only three agencies have successfully marketed issues which comply with the new law, and those issues either involve state subsidies not available in most states with the current budget crunch, or unique circumstances which cannot be replicated on a large scale.

For example, Wisconsin issued $10 million in revenue bonds this spring, but the State appropriated $600,000 to cover the issuing and administrative expenses of the bond issue. The State also provided a special $4 million escrow account to protect bondholders, should the bonds be declared taxable at some later date. In Colorado, two issues have been marketed, but under special circumstances in which a single bank purchased the bonds, processed the mortgage applications, made the mortgage loans, and serviced the mortgages.

S. 1348, introduced by Senator Sasser and co-sponsored by thirty others, and S. 1656, introduced by Senator Durenberger and co-sponsored by eight others, both address the technical barriers of the Mortgage Bond Subsidy Tax Act which have frustrated its policy objectives by preventing housing agencies from being able to issue mortgage revenue bonds. Unfortunately, however, Senator Durenberger's bill is not as comprehensive as S. 1348 and provides for a rate of arbitrage which will continue to frustrate the ability of the State of Louisiana to provide single family mortgages.

Only the Sasser bill will make it possible for Louisiana to operate a mortgage bond program, because it provides a rate of arbitrage-- 1.5 percent--adequate to allow us to cover the costs of a mortgage bond program out of the bond proceeds, without subsidies which simply are not available to us. The rate of arbitrage provided in the Durenberger bill--1.25 percent--is simply too low for us to be able to operate a mortgage bond program.

Under the 1980 Act, one percent is the maximum difference allowed between the interest rate paid on the issued bonds and the interest rate at which the bond proceeds can be lent to home purchasers. Prior to the Act, an arbitrage spread of 1.5 percent was allowed under Treasury regulations for mortgage subsidy bonds, just as it was and remains for all other forms of municipal finance for governmental programs. Those issues actually brought to market under the 1 percent limit have been heavily subsidized in some manner, either because the state or agency provided funds or because unique financial arrangements were created which cannot be replicated by most issues.

Although Congress obviously did not intend to eliminate mortgage revenue bonds, the 1 percent arbitrage restriction has effectively done so.

S. 1656 would increase the allowable arbitrage spread to 1.25 percent. The Louisiana program would not be helped by this increase, although some other state programs might be. One of three conditions must be present for a program to operate under the 1.25 limit. First, the housing agency must have been in existence for some time and accumulated funds of its own to subsidize an issue. Second, the state government must subsidize the program. Or, third, the agency must issue very large issues in the range of $60 to $100 million. Large issues help since as the size of a bond issue increases, the fixed costs associated with the issuance--such as printing and engraving the bonds, preparation of contractual agreements between the parties and computer time to calculate arbitrage--decline as a proportion of the bond proceeds which reduces the necessary arbitrage spread.

The Louisiana Housing Finance Agency is a new agency with no funds of its own to subsidize bond issues, and the demographics of our state preclude us from marketing very large issues. Therefore, only the Sasser bill, which would restore the historic and conventional 1.5 percent arbitrage allowance for mortgage revenue bonds, will make it possible for Louisiana to begin once more to conduct a mortgage bond program.

In addition to increasing the arbitrage limit, S. 1348 also makes useful technical changes in the method by which this "arbitrage spread" would be calculated in the case of mortgage prepayments and the calculation of the yield on mortgages. These changes would bring the Act into conformance with actual experience and practice.

A second problem in the 1980 Act which needs to be corrected is its unique and unfair "95 percent test." The Act provides that if at any time during the term of the bonds, usually 30 years, it is discovered that for any reason more than 5% of the homeowners in the mortgage bond program are ineligible to participate in the program, the interest on the bonds becomes taxable to the bondholders. This result would occur even if the Louisiana agency, or any other issuing agency, acted in good faith and had done its utmost to comply with all the provisions of the Act. This "95 percent test" exposes bond buyers to unfair, unprecedented and unacceptable risks which have drastically affected the marketability of housing bonds.

Bondholders in this situation are innocent bystanders who accepted the lower interest rates that tax-exempt bonds yield precisely because they are tax-exempt. With a cloud over tax-exempt status, which neither the bond holder nor the issuing agency can control, bond buyers will be naturally extremely reluctant to buy bonds which, through events totally beyond their control, might become taxable years after they are purchased.

Both S. 1656 and S. 1648 would allow the issuing agency to correct, within a reasonable time, any errors discovered in the course of administering a mortgage bond program which, if left uncorrected, would render the bonds taxable as the law is currently written. Under the Sasser bill, bond purchasers would be allowed to rely on a covenant included in the bond that pledges the issuer's good faith effort to comply with the law. That covenant guarantees the tax-exempt status of the bonds, unless the Secretary of the Treasury has published a notice of non-compliance prior to the sale of the bonds. Thus, unless a purchaser could have known of an issuer's record of bad faith, as evidenced by a published Treasury notice, the bonds will never be declared taxable after they are purchased.

State and local agencies will be "kept honest" by this provision. A failure to correct problems in an outstanding issue will result in an issuance of a devastating non-compliance notice by the Treasury which an agency would go to great lengths to avoid. Such a notice would effectively end that agency's mortgage bond activities.

S. 1656 would require all issuing agents to conduct periodic audits to insure that all persons receiving funds are indeed eligible under the terms of the Act. Either approach seems reasonable to me.

Both the Sasser and Durenberger bills would also end the discriminatory treatment for mortgage revenue bonds created by the Act's requirement that such bonds, uniquely among all municipal bonds, must be registered in the name of their purchasers As you might guess, the servicing of registered bonds is more expensive and bondholders resent the feature. Registration may drive up the interest rate on such bonds by as much as 50 basis points.

A fourth problem, addressed in S. 1348, is the prohibition against mortgage bond proceeds being used to assist owners of substandard or destroyed housing.

To assure that mortgage revenue bond programs are targeted to first-time home purchasers, the Act limits participation to persons who have not owned their home in the previous three years. This 3-year requirement has the unintentional effect, however, of prohibiting people who own substandard houses or who own houses destroyed by natural disaster from participating in mortgage bond programs, even if they meet all the other requirements of the Act.

An important goal of the Louisiana housing program, and I would think of any housing program, is to assist persons in acquiring safe, sanitary, and decent housing. State and local agencies should not be prevented from assisting an otherwise eligible person merely because he purchased a home that is a firetrap or no longer exists because of a flood or hurricane.

S. 1348 would allow homeowners to participate in a mortgage bond program if their home is certified by appropriate local officials as not meeting minimum property standards for sanitation, heating, structural soundness or crowding or if the homeowners have lost their home through a natural disaster. I believe this is a reasonable means of preventing the abuses Congress sought to prevent, while providing needy persons the opportunity to improve the quality of their housing.

A fifth problem arises because the Act provides that mortgage loans only be made for houses whose sale price is 90 percent or less of the "average area purchase price" during the most recent 12-month period in the statistical area in which the home is located. Unfortunately, the statistical data required to compute the average purchase price is unavailable for many areas of Louisiana, but especially in rural Louisiana where homes sales are infrequent, commonly undocumented, and where no such data is collected.

Treasury regulations, issued in August, have provided some relief by calculating state-wide "safe harbor" purchase prices. Thus, for areas where no data is available, this safe harbor provides guidance for determining "moderately priced." However, such a state-wide average inadequately reflects average prices in urban areas and rapidly growing rural regions where the housing market tends to be tighter and prices higher.

The Sasser bill would rely on the good faith of the issuing agent to determine whether a home met the moderately priced criterion, in the absence of published data. This provides the flexibility required to meet the situation of certain parts of Louisiana and other comparable states, which are not well-served by Treasury's safe harbor.

S. 1348 would also include areas experiencing rapid growth because of energy development in the definition of targeted areas under the 1980 Act. This increases the eligible sales price from 90 percent of the area average to 110 percent. Because much of Louisiana is now undergoing rapid growth related to energy development, housing prices are rising rapidly. Increasing the maximum price from 90 percent to 110 percent will assist persons find eligible housing in these "energy-impacted" areas.

State mortgage revenue bond programs are unable to benefit from participation in the VA program because the current law prohibits the assumption of any mortgage revenue bond mortgage by an ineligible person. Inadvertently, however, this bars the use of mortgage revenue bond proceeds with VA guarantees, since the VA program prohibits any restriction on the assumption of VA guaranteed mortgages.

S. 1348 would amend the current law to allow the assumption by noneligible persons, if the assumed mortgage is guaranteed by VA. The availability of VA guarantees reduces the interest rate at which state agencies can provide mortgages, since VA participation reduces the risk of mortgage default and thus the interest rate demanded by bond purchasers.

Finally, the Durenberger bill corrects a potential problem resulting from proposals to change Section 8 eligibility standards. Tax-exempt financing for multi-family residential projects is limited to those projects assisting low and moderate income persons, defined as those persons eligible for Section 8 assistance. Earlier this year, proposed budget-savings legislation would have changed

Section 8 eligibility from persons whose income is less than 80 percent of the area median to those with income of less than 50 percent.

That definitional change would have had a drastic effect on the feasibility of many multi-family projects. The Durenberger bill would free these projects from the Section 8 definitions, by defining low and moderate income as 80 percent or less of the area median. Developers of mixed income housing projects would then be able to proceed, regardless of the status of Section 8 eligibility standards. That freedom would certainly increase the stock of rental housing in Louisiana, an objective I heartily support.

Conclusion

As we embark into this era of "new federalism," the responsibilities placed upon state and local governments are increasing dramatically. As a state housing official, I look forward to meeting my share of that responsibility. But, to properly meet the housing needs of Louisiana citizens, we need the tools to do the job.

Mortgage revenue bonds have proven to be an efficient, workable tool for assisting people in obtaining housing. For state and local governments to make appropriate use of that tool, within the constraints of the policy objectives Congress established in the 1980 Act, the technical changes proposed by the Sasser and Durenberger bills must be made.

I cannot stress enough the need for urgent action. The Mortgage Subsidy Bond Tax Act terminates the use of single-family mortgage revenue bonds after 1983. State and local housing agencies were provided three years to utilize these bonds, we have already lost one year because of the technical problems I have discussed. The loss of any more time would truly be a tragedy for those eligible persons unable to purchase homes because of high interest rates. Prompt action to correct the deficiencies of the Mortgage Subsidy Bond Tax Act is required if housing agencies are to assist these persons.

I thank the Committee for its time and patience.

International Concerns Committee for Children
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A STATEMENT BY THE INTERNATIONAL CONCERNS COMMITTEE FOR CHILDREN ON TAX DEDUCTIONS FOR U.S. ADOPTING FAMILIES

On behalf of the International Concerns Committee for Children I wish to register our positive opinion that legislation should be passed permitting income tax deductions for adoption expenses involved in intercountry adoptions by U.S. citizens. We urge that Senate Bill 1580 be presented to and passed by the U.S. Senate.

As a national organization devoted to providing information about children in the world who are without parents to nurture and raise them, we are finding definite interest among U.S. citizens to open their hearts and homes to take these children as their sons and daughters forever. About 6 per cent of all adoptions annually in the U.S. are Americans adopting foreign children. These children usually come from developing nations in Asia and South America where there are no adoptive parents to raise these orphans, and where there are very minimum child welfare services.

Each U.S. citizen who adopts a foreign child must comply with the laws of the child's native country, and also must comply with the requirements of the Immigration and Naturalization Service of this country. The motivation and commitment of these adoptive parents is investigated and evaluated by both countries. The cost of adoption and legal services needed in the child's country and also those needed in the U.S. are paid by the adopting parents, along with the expense of bringing their child to this country. In some ways foreign adoption can be seen as a form of "ideal immigration" to this country of new citizens who will be raised and educated by loving American families to become contributing citizens here as adults.

Once the foreign child arrives in the U.S. the adoptive parents assume all the obligations and expenses, just as though the child were born to them. Therefore, it seems logical that the same type of tax deduction should be given to families adopting a foreign child as are available as medical expense deductions to those having children by birth. Unless adopted by U.S. families, these orphaned foreign children face very bleak futures. The death rate in Asian and South American orphanages is often 70%. Those surviving face a life with no education or skills in societies which often do discriminate against orphans during their whole lifetime. American families can offer life and hope to these children.

Betty K. Laning, President
International Concerns Committee for
Children

INTERNATIONAL CONCERNS COMMITTEE FOR CHILDREN

During the past several years there has been increased public interest in the plight of children throughout the world who do not have loving parents to care for them. Thousands of such children live in the "limbo" of institutional care, temporary foster care, or "on the streets". It has become apparent that accurate information on ways to assist such children in their own countries or by intercountry adoption has been extremely difficult to secure. Because these children are not able to speak for themselves, help for them must come from adult citizens of all countries who want to see these youngsters grow into happy, productive adulthood under the guidance of loving families of their own through adoption.

At present there exists no nationwide resource in the U.S. to which interested citizens, prospective adoptive parents, and adoption agencies can turn; a resource that has as its concern the welfare of children in foreign countries as well as those in the U.S.

INTERNATIONAL CONCERNS COMMITTEE FOR CHILDREN, a charitable and educational organization, has recently been incorporated as a Colorado non-profit corporation by experienced volunteers to fill this need with the following services:

1. To acquaint the concerned public and prospective adoptive parents with the various ways to provide assistance to homeless children; sponsorship, fostering, and adoption.
2. To educate those interested on the personal and professional level about the adoption process.
3. To inform prospective parents on the availability of the "waiting children" in foreign countries and in the U.S.

The activities of the INTERNATIONAL CONCERNS COMMITTEE FOR CHILDREN will include:

1. Providing an Information Service about the availability of adoptable domestic and foreign children.
2. Publication of an annual Report on Foreign Adoptions, with current updates.
3. Providing personal counselling in adoption by experienced adoptive parents for all interested parents and professionals.
4. Maintaining a Listing Service for foreign children in the U.S. whose adoptions have disrupted, and need new adoptive parents in this country.
5. Coordinating with adoptive parent groups to obtain current information on personal support and counselling on adoption.
6. Gathering and distributing pertinent information by recognized experts in adoption.

INTERNATIONAL CONCERNS COMMITTEE FOR CHILDREN's only funding is derived from public contributions. There are no fees for services other than nominal charges for related expenses.

We welcome your contributions to our efforts and invite inquiries in these specialized areas of adoption from the general public, and from those in the profession of child welfare.

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STATEMENT
OF THE AMERICAN BANKERS ASSOCIATION
ON
S. 1348 and S. 1656
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

October 30, 1981

The American Bankers Association is pleased to provide a written statement regarding the legislative proposals contained in S. 1348 and S. 1656, two bills which would amend or clarify certain provisions of the Mortgage Subsidy Bond Tax Act of 1980 (the Act). The membership of the American Bankers Association consists of more than 90 percent of the approximately 14,000 full service commercial banks, many of which underwrite and deal in tax-exempt bonds issued for housing purposes.

Our Association does not support either of these two bills or any other proposals which would eliminate or lessen the restrictions Congress last year placed on the use of tax-exempt mortgage revenue bonds. As you may recall, prior to the passage of the Act in December 1980, there were very grave concerns regarding the effects of tax-exempt mortgage bonds on the municipal securities market. It was brought to the attention of Congress through various studies made during 1980, that the growth of these types of tax-exempt securities had risen from less than $1 billion in 1974 to $12 billion in 1979 and accounted for more than one-quarter of all tax-exempt bonds issued in 1979. It was our belief then, as it is now, that the proliferation of such issuance would have a detrimental effect on the municipal bond market by "crowding out" other municipal issues sold for more traditional public purposes such as schools, roads and streetlights, thus increasing the cost for all municipal financing.

Additionally, we believe the municipal securities market today could not accept the amount of tax-exempt mortgage revenue bonds which the markets handled in prior years. Municipal borrowing for all purposes, public and private, is getting much more difficult as demand intensifies. Why, then, should we loosen the restrictions on the issuance of municipal mortgage revenue bonds in order for these securities to compete with other, more traditional government projects, projects which are in the realm of municipal services offered to all taxpayers?

Just recently, as part of the Economic Recovery Tax Act, commercial banks, savings and loan associations, credit unions, and others were authorized to issue "All Savers" certificates of which $1,000 for an individual or $2,000 for couples is exempt from federal income taxes. One of the primary purposes of the "All Savers" was to link the money received by these institutions to mortgage financing for those seeking housing funds. Since the proceeds of these funds are tied directly to mortgage financing, we see no additional need for a relaxation of the requirements addressed in the Mortgage Subsidy Bond Tax Act of 1980.

The growth of tax-exempt financing for private purposes has in the past few years, also resulted in a revenue loss to the Treasury. Our Association is concerned with the efficiency of such programs vis-a-vis the financial deficit created by its use.

The American Bankers Association believes the Act of 1980 has worked as Congress intended. We feel the restrictions contained in the provisions of the Act are workable and would not support a lessening of such restrictions.

STATEMENT OF ANTHONY GLIEDMAN, COMMISSIONER OF THE DEPARTMENT OF HOUSING PRESERVATION AND DEVELOPMENT OF THE CITY OF NEW YORK AND CHAIRMAN OF THE NEW YORK CITY HOUSING DEVELOPMENT CORPORATION BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE - UNITED STATES SENATE - OCTOBER 16, 1981

I am pleased to have the opportunity to submit testimony to the Subcommittee on Taxation and Debt Management of the Senate Finance Committee as the Commissioner of the Department of Housing Preservation and Development of the City of New York ("HPD") and as Chairman of the New York City Housing Development Corporation ("HDC"). I wish to express support for S. 1656, because passage of the bill, which amends and clarifies certain provisions of the Mortgage Subsidy Bond Act of 1980 that relate to tax-exempt financing for housing would have a beneficial impact on the nation's housing supply. My comments reflect the experiences and needs of the city and agencies I represent. However, I believe that New York City's concerns are similar to those of many localities facing a crisis in the production of housing affordable to low and moderate income families. Enactment of S. 1656 is vital if New York and its sister cities are to be able to meet their housing needs.

Before commenting on the need for the proposed legislation and its merits, as well as on additional modifications to the Mortgage Subsidy Bond Act of 1980 not currently included in S. 1656, I would like to describe HPD and HDC and explain the City's interest in the legislation's passage.

HPD was established in 1977 and is responsible for all programs of the City of New York relating to publicly assisted housing, neighborhood preservation and urban renewal. HPD also manages property of the City which it acquires for housing and urban renewal purposes and is responsible for the enforcement of all laws relating to the rehabilitation of housing in New York City.

HDC was created by the State of New York in 1971 to facilitate the investment of private capital in multifamily housing. By financing project mortgages with tax-exempt bonds, HDC has been able to provide decent, safe and sanitary housing for approximately 39,000 families of low and moderate income. The City of New York would like HDC to continue to expand its programs in order to meet the growing need for affordable housing.

Of course, there is a debate whether a need exists for greater production of multifamily housing. I believe that Congressman Green in his testimony has accurately assessed the current housing problem throughout the nation. Let me touch briefly on the housing needs of New York City. According to the City's federally approved Housing Assistance Plan over 870,000 households within the City are in need of some form of housing assistance. Either they reside in substandard housing, are overcrowded or pay a burdensome percentage of their income for rent. These problems are particularly severe for minority, elderly, handicapped and female-headed households. Exacerbating this situation is a continued and severe slump in housing production. For the 1970-74 period, the average annual number of construction starts in New York City stood at 25,800. From 1975-80, the average fell to 8,400. The low level of production has placed considerable stress on the City's housing market where the vacancy rate is less than 3%. In the most stable areas, the rate is considerably lower.

Of course, lack of production tells only one side of the story of the City's housing shortage. Skyrocketing inflation and interest rates over the past decade continue to widen the gap between the cost of maintaining housing and the ability of New Yorkers to pay rent. This gap has widened to the point where landlord disinvestment and abandonment have reached epidemic proportions. Private investment in low and moderate income rental housing has almost disappeared. The City has made use of Section 8 substantial and moderate rehabilitation funds to upgrade multiple dwellings in low income areas. In addition, the City has a long history of committing its own resources to housing through below market rate loans and tax exemptions and abatements. The City has used the tax foreclosure law to take possession of much of the City's decaying low and moderate income stock in an effort to prevent eventual abandonment and total loss. As of December, 1980, the City had nearly 55,000 units of housing in some type of in rem property management program.

We seek changes in the Mortgage Subsidy Bond Tax Act of 1981 (the "Act") to enable us to finance the construction or rehabilitation of units for families of low and moderate income. These amendments may entail some minimal costs. However, in comparison with the price tag of other Federal housing programs, the cost is modest indeed.

The Act was designed to ensure that at least some portion of each multifamily project which receives the benefit of tax-exempt financing is targeted to low and moderate income tenants. However, at the time the Act was passed, recent developments such as deep Section 8 budget cuts, substantial reductions in GNMA funds and high interest rates were not anticipated by Congress. In addition, technicial problems have made complying with the Act difficult. Thus, it has been virtually impossible to issue tax-exempt obligations for multifamily housing since the Act's passage in December 1980.

The Act urgently needs modification in order to make it a viable housing production vehicle. We strongly support S. 1656 as a beginning. S. 1656 addresses three requirements of the Act which seriously impair the ability of housing agencies to issue tax-exempt obligations for multifamily housing: (1) the term of the occupancy requirements; (2) the linkage of tenant eligibility criteria under the occupancy requirement to the Section 8 statute and regulations; and, (3) the registration requirement.

Term of Low Income Occupancy Requirement

The Act currently requires that at least 20% (15% in targeted areas) of the units in any multifamily project financed with the proceeds of tax exempt bonds be occupied by tenants eligible to receive assistance under Section 8 of the United States Housing Act of 1937, as amended. During initial legislative deliberations on the Act, however, it became apparent that this approach was impractical since Section 8 assisted projects, which were anticipated to constitute the great bulk of the production, generally had Section 8 contracts for periods less than the mortgage or bond term; where an FHA insured mortgage is involved, for example, the maximum term of the Section 8 housing assistance contracts is 20 years while the mortgage and bonds run for more than 40 years. Because of this fact it was recognized that following the expiration of the Section 8 contracts (after 20 years) the tax exempt status of such obligations would be in jeopardy.

To deal with this problem the Ways and Means Committee inserted a 20 year safe harbor provision, which was eventually included in the Act as a transition rule. This rule provides that, until 1984, the applicable percentage requirement for low and moderate income units must be satisfied for only the first 20 years the bonds are outstanding. While this transition rule may have temporarily taken care of the occupancy problem for Section 8 new construction and substantial rehabilitation projects, tax-exempt financings under HUD's moderate rehabilitation Section 8 program are not currently feasible. The contract term under the HUD Section 8 moderate rehabilitation, property disposition and loan management set aside programs is limited to 15 years.

S. 1656 would make the occupancy requirement apply for a period commencing upon the first date on which a unit in a project financed with tax exempt obligations is occupied, and ending on the later of the tenth anniversary of the first occupancy of a unit in the project, the expiration of a period equal to one-half the term of the tax exempt obligations or the date on which assistance provided to the project under Section 8 terminates.

This proposal seems to take the current transition rule to its logical conclusion. It appears to have been the intent of the conferees that the period during which the low income occupancy requirement applies should be flexible enough to correspond with the term of the Section 8 contract. At the time the conferees agreed to the 20 year transition rule they were focusing on the maximum 20 year term for the Section 8 new construction and substantial rehab projects commonly being utilized at that time; tax exempt financings with moderate rehab Section 8 assistance had not been structured at that time and consideration was apparently not given to the need for a more flexible rule. The amendment would also convert the transition rule into a permanent rule and facilitate moderate rehabilitation Section 8 financings.

We support this change but think more thought should be given to the question of the length and manner in which a low income occupancy requirement should be structured in view of federal initiatives to limit rent subsidies to 5 year terms. The manner in which the occupancy requirement is to be met should be flexible so that localities may develop innovative mechanisms to assist low income tenants. In addition we think the construction period should be specifically excluded from the term of the bonds for purposes of calculating the term of the occupancy requirement for low income tenants.

Low Income Tenant Eligibility

S. 1656 would clarify the definition of individuals of low or moderate income rather than linking the definition of qualified individuals to Section 8 provisions. The amendment would retain the current income limits for the purposes of tax exemption at 80% of area median.

The Act currently relies upon the Section 8 program's definition of individuals of low or moderate income, which is 80% of area median or less. However, potential ambiguity was created through the enactment of the Omnibus Budget Reconciliation Act of 1981 which provides that no more than 10% of dwelling units which are available for occupancy under the Section 8 or public housing programs before October 1, 1981, and are leased on or after that date may be leased to tenants whose income is between 50% and 80%

of area median and that no more than 5% of all dwelling units which become eligible for occupancy under the Section 8 and public housing programs on or after October 1, 1981, may be leased to tenants with incomes of between 50% and 80% of area median. Although the Conference Report provides that this limitation upon tenant eligibility was not intended to affect the conditions established for project eligibility under Section 103(b)(4)(A), the Act itself should be amended to eliminate any potential unintended ambiguity created by the Omnibus Reconciliation Act of 1981.

Registration Requirements

Finally, S. 1656 would eliminate the registration requirements currently imposed for tax exempt obligations issued for multifamily rental housing. The requirement of registration of these obligations simply creates additional administrative costs and burdens and also increases the yields of bonds. This puts them at a competitive disadvantage in the marketplace and ultimately increases the costs of housing. So long as all municipal bonds are not required to be registered, this burden should not be placed upon bonds for housing.

Technical Point Not Covered by S. 1656

The Act does not specify whether blanket mortgages for cooperative housing are to be treated as multifamily housing mortgages for the purposes of Section 103(b)(4)(A). We feel strongly that the underlying cooperative housing mortgages should be treated as multifamily rental housing mortgages for the purposes of the Act. We urge amendment of Section 103(b)(4)(A) to make this clear. Cooperative housing bears a greater similarity to multifamily rather than single family housing. In both a cooperative and a multifamily rental project there is one blanket mortgage made by the project's owner to a lender and the tenants in both types of projects pay rent to the owner of the project. Of course, in the case of a cooperative, individual tenants are also shareholders in the cooperative housing company which owns the project and may have other individual loans to finance their shares in the cooperative housing company. Tax-exempt financing of blanket cooperative mortgage loans under the multi-family provisions of the Act is essential.

Although cooperators do enjoy some benefits not generally afforded to renters, we feel that underlying cooperative mortgages nevertheless deserve to be treated as multifamily rental housing mortages under the Act. A number of different programs adopted and administered through the years by Congress and the Department of Housing and Urban Development (including the Section 8 program and FHA insurance programs) have treated cooperative housing as multifamily rental housing. In its budget outline for 1983, HUD also has suggested that this proposed change be permitted.

The treatment of cooperative housing as multifamily housing for the purposes of the Act is vitally important to New York where it has played a large role in providing housing in the City for decades. Cooperative housing is an accepted vehicle for housing production in New York and a significant portion of New York City's housing stock is in the cooperative form. This rule would therefore significantly broaden the nature and type, as well as quantity, of housing opportunities which the City can make available to low and moderate income individuals.

Additional Substantive Changes Required

S. 1656 makes important technical changes in the Act which are essential. However, additional modifications in the Act are required to facilitate production of much needed rental housing.

We urge consideration of an occupancy requirement which would be based on the aggregate number of units in all projects financed by an issuer of tax exempt obligations, rather than the current occupancy requirement which applies on a project-by-project basis. This would change the occupancy requirement for tenants who are low income persons from the current 20% of the units in each project financed with tax exempt obligations to 20% of the aggregate number of units in all projects financed by an issuer through the proceeds of tax exempt obligations issued on or after the effective date of the Act.

Under this occupancy requirement as long as 20% of the total number of units financed by an issuer through its tax exempt obligations after the effective date of the Mortgage Subsidy Bond Tax Act are or are to be occupied by eligible tenants, the individual projects financed by an issuer need not meet any specified percentage of low and moderate income tenancy. Occupancy requirements based upon the aggregate of all the units in all projects financed by an issuer should result in allocation of Section 8 units to projects where the greatest need exists. Adoption of an occupancy requirement based on an aggregate number of low income units can of course result in financings for projects without any units being occupied by tenants with incomes below 80% of median. This would increase the total available rental housing stock with significant residual effects including increased housing opportunities available to low and moderate income individuals. It will also permit issuers to utilize more effectively other federal, local and state assistance programs and would reduce the competition for scarce Section 8 units. It may, however, be appropriate to require all units financed under the Act to be maintained as rental or qualified cooperative housing for some minimum period of time.

This country is facing a crisis in its effort to provide housing to meet growing needs and demands. Nationwide, rental housing vacancy rates are at an all time low. As a result of current economic conditions the production of new housing units has fallen dramatically. Tax exempt financing presents an important vehicle to facilitate the production of rental housing which can result in increased housing opportunities for low and moderate income families at a time when most other direct federal assistance is being withdrawn. Despite this reduction in federal assistance decent and safe rental housing for low and moderate income households is essential. The ability to produce multifamily housing is in serious jeopardy. We strongly support the enactment of the multifamily provisions of S. 1656 and urge the inclusion of the additional changes which I have enumerated. These changes would constitute a major step forward while preserving and implementing the objectives of the Act.

The urgent need for more multifamily housing production requires more than the technical amendment to Section 103(b)(4)(A) proposed in S. 1656, particularly if the proposed changes in federally assisted housing programs are enacted in the coming years. However, enactment of the amendments proposed in S. 1656 along with the proposal discussed above with respect to the treatment of cooperative housing under the multifamily provisions of the Act are imperative at this time. At a minimum: (1) the term of the occupancy requirement must be shortened so that HUD Section 8 moderate rehabilitation, property management and loan disposition projects may have an opportunity to be financed with the proceeds of tax exempt obligations; (2) clarification of the tenant eligibility criteria by defining low and moderate income individuals for the purposes of Section 103(b)(4)(A) is imperative, (3) cooperative housing must be treated as residential rental property for purposes of Section 103(b)(4)(A) and (4) the registration requirements for housing bonds must be dropped.

I appreciate this opportunity to submit testimony to the Committee on these areas of vital concern to New York and other cities and urge the Committee to give favorable consideration to the proposals before you.

TESTIMONY OF

MATTHEW B. SLEPIN, DIRECTOR OF GOVERNMENT AFFAIRS
NATIONAL ASSOCIATION OF HOUSING COOPERATIVES

REGARDING THE TREATMENT OF HOUSING COOPERATIVES IN THE TAX-EXEMPT MORTGAGE REVENUE BOND PROGRAM

SUBMITTED TO THE SENATE FINANCE COMMITTEE

OCTOBER 30, 1981

Testimony on Mortgage Revenue Bonds
National Association of Housing Cooperatives
October 30, 1981

Mr. Chairman. My name is Matt Slepin. I am the Director of Government Affairs for the National Association of Housing Cooperatives, a trade association representing families living in over 500 housing cooperatives across the country. The National Association serves to promote successful operations of existing cooperatives as well as the development of new housing cooperatives.

The Mortgage Subsidy Bond Tax Act of 1980 was not clear in its treatment of housing cooperatives. The Conferees' Report stated that "a share in a cooperative housing corporation...[is] treated as [a] single family residence..." No mention in either the statute or the Conferee's Report was made of cooperative project finance.

Housing cooperatives have a unique legal structure. In a condominium, each family is the "fee-simple" owner and title holder of their unit. In a cooperative, however, the cooperative corporation itself-- not the individual members-- owns and holds title to the property. Individual members own a membership certificate or shares of stock, which entitles them to reside in a specific unit.

Due to this arrangement, cooepratives are usually financed with a single underlying project or "blanket" mortgage. A typical cooperative utilizing FHA 221(d)(3) or 213 mortgage insurance takes out a blanket mortgage for either 100% or 98% of the project cost respectively. Initial membership fees make up the difference between the mortgage amount and total project and development cost, which includes the establishment of reserve funds.

It is this combination of underlying blanket finance and modest membership fees that allows housing cooperatives to serve as a homeownership option affordable to families of all income levels. Because the cooperative and not its individual members is the mortgagor, an incoming member can qualify to be a cooperative homeowner without having to individually qualify for a unit mortgage. In addition, the blanket mortgage is held long-term by the cooperative and is not refinanced every time a unit changes hands. Hence, many cooperatives around the country continue to pay debt service on 20-year-old, 6% mortgages. Monthly carrying charges are significantly below market and, as you can imagine, waiting lists are commonly several years long.

Project financing is basic to cooperative housing. For this reason, we are concerned that the Treasury Department, in its forthcoming regulations on Industrial Development Bonds for housing, will interpret the 1980 Act's silence on this matter as a directive to discontinue tax-exempt financing for cooperative blanket mortgages.

It could not have been the intent of Congress to shut cooperative blanket finance--which would mean virtually all cooperative activity for low and moderate income families--out of the tax-exempt program. It is our interpretation, therefore, that the 1980 Act's silence on this matter means that cooperative projects can continue, as before, to be financed under the tax-exempt program similar to other multifamily housing.

As the Members of this Committee are well aware, the intent of the Ullman legislation was to curtail the financing of speculative, ownership housing under tax-exempt programs. The bill was a response by Congress to tax-exempt dollars being used to finance luxury, single family, detached homes. The solution decided upon was to split the tax-exempt program into two parts--single family and multifamily.

Both United States tax laws and HUD/FHA programs have treated cooperatives as multifamily housing. Cooperative corporations are subject to regular corporate income tax rules. In 1976, Congress amended Section 216 of the Internal Revenue Code to allow housing cooperatives to utilize standard depreciation deductions. In doing so, the Senate Finance Committee emphasized the multifamily nature of cooperatives. The Committee wanted to "insure that a cooperative housing corporation is entitled to a deduction for depreciation with respect to the property it leases to a tenant-stockholder..." (1976-3 C.B. Vol.3, p.435.) In addition, the legislative history of Section 216 clearly establishes that the tax owner of a cooperative housing project is the corporation which holds title to the project, rather than its members.

Many would argue that, since cooperative members are entitled to receive the "homeowner's tax deductions" through Section 216 of the Internal Revenue Code, that cooperatives are ipso facto single family housing. We disagree. Admittedly, cooperative housing is somewhat of a hybrid. Legal treatment of housing cooperatives must be decided by the merits of a situation rather than a desire to consistently categorize cooperatives as rental or ownership housing. In this case, because cooperatives rely upon blanket financing, they should be eligible to receive Industrial Development Bond proceeds.

NAHC recently commissioned a study, which is submitted as "Appendix A", that shows conclusively that the U.S. Treasury loses less tax revenue by financing a cooperative rather than a rental. Even though each cooperative member is entitled to receive the homeowner's tax deductions, the study shows that the loss in revenue to Treasury is less than if a comparable property was owned by a limited dividend partnership and operated as a rental. Hence, the argument that cooperatives and their members would "double dip" on tax breaks if eligible for tax-exempt bonds, is moot.

If eligible for Industrial Development Bonds, cooperatives would have to meet the 20% low-income occupancy requirement. In contrast to rental properties, cooperatives would have to maintain affordability of membership-share prices as well as monthly carrying charges. Many cooperatives already do this by limiting the price of membership resales. Commonly called "limited equity" cooperatives, these cooperatives tie the price of membership resales to the original membership price rather than the market value. A return on the initial investment is allowed that is usually tied to a price index such as the Wage-Price Index or the Consumer-Price Index. Resale price can also be tied to the outgoing member's paydown on the blanket mortgage.

In today's housing market, cooperatives offer a unique form of housing that combines affordability with homeownership. For low and moderate income families living in "limited equity" cooperatives, homeownership does not mean speculative investment, but control over their community and pride in their housing.

The current Administration is extremely interested in promoting cooperative housing. In fact, the Housing Policy Task Force to President-elect Reagan, Chaired by former HUD Secretary Carla Hills, said that "the task force recommends that the Administration explore ways of facilitating ownership of assisted housing projects by tenants...the most obvious form for low-income ownership is the cooperative."

Treasury needs direction from Congress in interpreting the 1980 legislation as it pertains to housing cooperatives. As I said before, Congress does not need to pass legislation on this matter. But the Committee should clarify the intent of last year's legislation so that Treasury has a clear directive on cooperatives prior to issuing the Industrial Development Bond regulations.

Mr. Chairman, thank you for the opportunity to submit our testimony. I trust that the Committee will act promptly to allow housing cooperatives to utilize the tax-exempt financing program. If I can be of further assistance to the Committee in its deliberations, please feel free to call upon me.

APPENDIX "A"

A COMPARATIVE ANALYSIS OF TAX EXPENDITURES IN COOPERATIVE VS. RENTAL HOUSING

presented by : Matt Slepin, Director of Government Affairs
National Association of Housing Cooperatives

prepared by : Dennis Eisen and Associates

presented to : Senate Finance Committee

A COMPARATIVE ANALYSIS OF TAX EXPENDITURES IN COOPERATIVE VS. RENTAL HOUSING

Summary: This paper rigorously establishes that the deductibility of mortgage interest and real estate taxes to tenant-stockholders of cooperative housing corporations under Section 216 of the Internal Revenue Code will result, in almost all instances, in a significantly lower tax expenditure to the U.S. Treasury than had the same multi-family project been owned and operated as rental residential property.

I. Introduction

According to Section 216 of the Internal Revenue Code, a tenant-stockholder in any cooperative housing corporation may deduct his or her proportionate share of real estate taxes and mortgage interest. This paper examines the extent to which the tax expenditures resulting from such deductions are either greater or less than the equivalent level of tax expenditures had the very same multi-family project been owned and operated as a rental residential apartment building.

Although real estate taxes and mortgage interest are certainly deductible to the investor-owner of rental residential property, these deductions, as well as the other operating expenses of the property, are netted against rental income. In the case of tenant-stockholders in a cooperative housing corporation, the deductions for taxes and interest are netted against personal incomes, not the imputed rents associated with the property. Of primary importance also is the ability of the investor-owners of rental residential property to depreciate the physical structure. As a tax expenditure, however, the effect of depreciation is mitigated by its recapture as capital gains and/or ordinary income upon eventual sale of the property.

To resolve the issue of relative tax expenditures incurred, the National Association of Housing Cooperatives commissioned a series of computer simulations of the financial and economic history of four hypothetical, but very representative, multi-family projects. In each instance the project was simulated as being operated as a rental residential apartment project, and then simulated as being operated by a cooperative housing corporation for the benefit of tenant-stockholders.

The end product of each such pair of computer simulations was the stream of tax expenditures over a twenty-year history of rental versus coop operation. Using a 10 percent per annum discount rate, as is recommended by the Office of Management and Budget for use with Government Programs, each such stream of tax expenditures was also reduced to its present value equivalent in terms of 1981 dollars.

II. The Projects

As mentioned in the Introduction, four representative multi-family project types were considered. They were: (1) new construction, with conventional, market rate financing; (2) new construction, with tax exempt financing and occupants consisting of low- and moderate-income families; (3) rehab'd construction, with conventional, market rate financing; and (4) rehab'd construction, with tax exempt financing and occupants consisting of low- and moderate-income families. The physical, financial and ownership characteristics of each project type are described below.

A. Cost Parameters

From the viewpoint of the physical characteristics of the projects, there were only two separate types involved: new and rehab'd construction.

(1) New Construction. The proto-typical new construction project selected for analysis is that of a 100-unit garden apartment complex with each unit about 875 square feet. The hard costs of construction are estimated as

$35,000 per unit; land cost at $10,000 per unit; and the soft costs except for construction-period interest and taxes as another $10,000 per unit. Construction-period interest is estimated as $6,500 per unit over a one-year construction period and construction-period taxes another $500 per unit. The total construction cost has therefore been estimated as $62,000 per unit. For the purposes of this paper, we may presume, without loss of generality, that this cost is independent of whether built conventionally or to meet HUD minimum property standards and regulations.

(2) Rehab'd Construction. The proto-typical rehab'd project of 100 units is assumed to be originally acquired for about $15,000 per unit (of which half the cost may be allocated to land and half to the building). Rehab costs are estimated as another $15,000 per unit, plus soft costs other than construction-period interest and taxes of $7,500 per unit. Construction-period interest is estimated as $4,500 per unit over a nine-month construction period and construction-period taxes another $500 per unit. The total acquisition and construction cost has therefore been estimated as $42,000 per unit. We again presume that this cost is independent of whether rehab'd conventionally or to meet HUD minimum property standards and regulations.

B. Financing Parameters

The permanent financing on conventionally built or rehab'd structures is assumed to be 75% of cost @ 16% for 30 years. The permanent financing on all units, new or rehab'd, destined for low- and moderate-income families is targeted as 90% of cost @ 11½% for 30 years. The principal is assumed raised from the sale of tax exempt bonds and the mortgage insured by HUD or equivalent agency. To reflect the insurance, there is also included a mortgage insurance premium of ½% per annum. In summary form, we have:

(1) New/Conventional: A mortgage of $4,650,000 @ 16%, 30 years, with P&I payments of $7,504 per unit per year.

(2) New/Low & Moderate: A mortgage of $5,580,000 @ 11½% + ½% M.I.P., 30 years, with P&I and M.I.P. payments of $6,888 per unit per year.

(3) Rehab'd/Conventional: A mortgage of $3,150,000 @ 16%, 30 years, with P&I payments of $5,083 per unit per year.

(4) Rehab'd/Low & Moderate: A mortgage of $3,780,000 @ 11½% + ½% M.I.P., 30 years, with P&I and M.I.P. payments of $4,666 per unit per year.

C. Operating Expenses

In the case of new construction, the first year's operating expenses exclusive of management fees have been estimated as about 4½% of construction cost, or $2,800 per unit per year. These are comprised of property taxes of about 2%; maintenance, repair and replacement reserves of about 1.5%; and utilities and insurance of about ½% each. In the case of rehab'd construction, the first year's operating expenses exclusive of management fees have been estimated as 5% of total acquisition and construction cost, or $2,100 per unit per year. (Maintenance repair and replacement reserves are estimated as closer to 2.0% of cost for the rehab'd units, the other percentages as estimated for new construction.)

In all cases, management fees and allowances for vacancies and bad debts are estimated as 10% of gross scheduled income.

D. Rental Income

For the purposes of this paper, we shall minimize initial project cash flow and specify the first year's rent as being set to just break even. That is, rental income will be the combined costs of debt service and operating expenses, divided by a factor of .90 (to account for management and vacancy). We have, per unit per year:

(1) New/Conventional: Rent = (7,504 + 2,800)/.9 = $11,448

(2) New/Low and Moderate: Rent = (6,888 + 2,800)/.9 = $10,764

(3) Rehab/Conventional: Rent = (5,083 + 2,100)/.9 = $ 7,981

(4) Rehab/Low and Moderate: Rent = (4,666 + 2,100)/.9 = $ 7,518

The first two rent levels indicate why there has been such a dearth of new, unsubsidized rental residential construction in recent times. Families allocating one-third of their income to such rent would have to be earning almost $35,000 per year.

E. Expenses and Income Inflation Rates

Throughout the 20-year simulated history of each project's operation, it is assumed that operating expenses (taxes, maintenance, utilities and insurance) are rising at 10% per year. In the case of conventional housing, the corresponding rents will be presumed to increase at the annual rate of 6½% per year. In the case of low- and moderate-income housing, the corresponding rents are presumed limited to dollar-for-dollar increases with rising expenses.

F. Future Value

The future value of the conventional projects is assumed determined by the capitalization of net operating income. For the purposes of this paper, a capitalization rate of 12% has been utilized. This rate was determined by relating the construction cost and initial net operating income. For the new/conventional project, the net operating income is 90% of $11,448, less $2,800, or $7,503 per unit per year. For the rehab/conventional project, the net operating income is 90% of $7,981, less $2,100, or $5,083 per unit per year.

The capitalization rates are therefore estimated as:

Cap Rate (New/Conventional) = $7,503/$62,000 = 12%

Cap Rate (Rehab/Conventional) = $5,083/$42,000 = 12%

Applying the capitalization rate of 12% to the net operating income expected during the 20th year of simulated operation yields an estimated future value of the new/conventional project of about $14.1 million. Doing the same with the rehab/conventional project yields an estimated future value of about $9.1 million.

Because of the fact that the net operating incomes of the two low- and moderate-income projects are assumed to remain invariant with time, the projected future values in both cases are presumed to be the same as the original costs of construction.

G. Disposition and Sale

To simulate the capital gains effect over time, it is assumed that the investor-owners of the rental units sell out at the end of a 20-year holding period. An all-cash transaction is presumed, with the capital gains and ordinary income taxes due upon sale being paid at that time.

In the case of the tenant-stockholders, the usual course of events upon sale, if and when it occurs, is for the reinvestment of the proceeds of sale into subsequent housing units. For such individuals, the roll-over provisions of the Internal Revenue Code, coupled with the $125,000 exclusion on the amount of gain from the sale or exchange of a principal residence by individuals over 55 years of age, assure an almost indefinite postponement of any tax consequences of sale.

In all instances of rental residential projects, it is assumed that between real estate commissions, legal fees, and miscellaneous costs, the overall expenses of sale will be 6 percent of the projected value of the property at the time of disposition. This consideration does not enter into the calculation of the corresponding tax expenditures for the tenant-stockholders in the cooperative housing corporations becasue of the indefinite postponement of the consequences of sale.

H. Refinancing

In the two cases of conventional rental residential projects, we presume that the owner-investors will seek to maximize the rates of return on invested capital by periodically refinancing the mortgage or by borrowing additional funds against the equity in the projects. Such a mechanism has the practical effect of converting the capital gains created by increasing property value into non-taxable withdrawals of capital, and is a standard device in the field of conventional rental residential investment. Because of the lack of increase in property value for the low- and moderate-income rental projects, plus the prohibition by HUD on secondary mortgage financing, this option is typically unavailable to investors in such projects.

The specific refinancing mechanism assumed in the computer simulations has been for the investor-owners to leave the first mortgage in place at all times, but to borrow an amount of capital every fourth year which will bring the loan-to-value ratio up to 85 percent. It is further assumed that these funds are borrowed at a second mortgage interest rate of 20% per annum with payments of interest only. To be very specific, these additional borrowings were assumed to take place exactly four times during the 20-year simulated history of project operation, at the end of years 4, 8, 12 and 16.

There was no refinancing or additional borrowing permitted the tenant-stockholders in the equivalent cooperative housing corporations.

I. Depreciation

One of the most important benefits to the investor-owners in the rental residential projects is the ability to write off a certain portion of their investment each year in accordance with schedules prescribed by the Internal Revenue Code. These rules are significantly different for conventional vs. low- and moderate-income residential properties.

For conventional rental properties, investor-owners must capitalize construction-period interest and taxes, and, when this provision of the Code is fully phased in, must write off this item over ten years in a straight-line manner (i.e., at 10% per year). The total acquisition costs, exclusive of land, are then depreciated over 15 years at either a straight-line or 175 percent declining balance schedule. In the latter case, excess depreciation (the difference between the cumulative depreciation under the declining balance and straight-line methods) is recaptured as ordinary income upon ultimate disposition and sale. For the purposes of this paper, the 15-year accelerated schedule has been selected. Since we have adopted a 20-year investment horizon, there will be, however, no excess depreciation to be recaptured as ordinary income (as the investment is fully depreciated by the end of the 15th year).

For the low- and moderate-income rental projects, investor-owners may expense construction-period interest and taxes as accrued, without having to capitalize them. In addition, the remaining costs of acquisition, exclusive of land, are then depreciated over 15 years at either a straight-line or 200 percent declining balance schedule. (In the latter case, the recapture of excess depreciation as ordinary income is relaxed at the rate of 1% per month after the first 100 months of ownership.) We have selected the 200 percent declining balance schedule for the purposes of this investigation. The 20-year investment horizon adopted again insures no excess depreciation by the time of sale.

For the rehab of low- and moderate-income projects, the qualified rehabilitation expenditures may be written off under Section 167(k) of the Internal Revenue Code in a straight-line manner over a 60-month period. To qualify, the rehab expenditures must be at least $3,000 per unit but not exceed $20,000 per unit ($40,000 per unit if leased or sold to the occupants at cost).

J. Federal Income Tax Brackets

The investor-owners of the rental residential projects are all presumed to be in a 50% Federal income-tax bracket.

For the tenant-stockholders in the cooperative housing corporations, things are not so simple, and deeper consideration must be given to the income level of the average resident found in each type of coop, as well as the new marginal tax tables to be put in place. We have presumed in all instances that the first $2,000 of mortgage interest and real estate taxes paid by each tenant-stockholder each year is used as a partial offset to the zero-bracket amount. For deductions of interest and taxes above that amount, and based upon average incomes found among the occupants of the four typical project types developed, the following marginal Federal income-tax brackets have been utilized in the analysis:

Case	Tax Bracket
(1) New/Conventional:	25%
(2) New/Low & Moderate:	13%
(3) Rehab/Conventional:	18%
(4) Rehab/Low & Moderate:	11%

The marginal tax rates for conventionally financed projects were arrived at by taking a faimly of three with incomes either three times greater (rehab) or three and a third times greater (new) than the initial annual housing costs of $7,981 and $11,448, respectively. Excess itemized deductions of $2,000 for the resultant $24,000 gross income levels (rehab) and $6,000 for the $38,000 gross income levels (new) were then allowed for, a consequence of the fact that as family incomes go up, amounts of excess itemized deductions increase at even a faster rate. The resulting taxable incomes were taken to the tables of tax rates for years 1983 and thereafter. No specific consideration was given to the new provisions for removing interest income from tax, or other new provisions which, generally, would operate to reduce taxable income at higher levels.

Tax rates for low/moderate families were more complicated to approach. Family income is, by definition, lower than would be indicated by the 3x rule of thumb. Additionally, there is believed to be a greater portion of income from non-taxable sources, including social security, disability, child support, unemployment compensation, etc. Family composition, also, may vary from conventional, having both more single-parent households and some tendancy for larger family size. An unstructured sampling of existing housing cooperatives in the Washington, D.C., area revealed an indicated average family income of $12,000 to $18,000 from all sources. Taking account the fact that not all of this income would be taxable, that incomes in Washington, D.C., would tend to be higher than other parts of the country, and that the lower cost housing would be occupied by people whose real and taxable incomes fell as low as zero, incremental rates of 13% and 11% were estimated.

III. Methodology

A. Tax Expenditures

The general approach taken to the calculation of tax expenditures is first to define the concept in a precise quantitative fashion.

To do this, let us denote by PV the present value of the after-tax cash flow stream associated with the operation of the rental residential properties on the part of the owner-investors. This cash flow stream consists of the initial equity advanced on or before project opening, the net after-tax cash flow proceeds arising from annual operations, the special withdrawals of capital coming from the periodic refinancings, if any, and the net after-tax proceeds of sale at the end of 20 years. Discounting each component of this stream back to its present value in 1981 at a discount rate of 10% and summing the results yields the present value of the investment. In other terms, PV is the after-tax profit, expressed in 1981 dollars, obtained over the 20-year investment period involved.

To calculate the tax expenditure for the rental residential projects, suppose we first compute the present value of the investment for an investor-owner in a 50% Federal tax bracket, denoting the result by PV(50%). We next repeat the procedure for an investor-owner in a zero percent Federal tax bracket, denoting the result by PV(0%).

The only difference between these two investor histories is that due to the operation of the Internal Revenue Code as it affects before-tax cash flows. Because of this, the difference PV(50%)-PV(0%) will be taken as the definition of the tax expenditure for the purposes of this paper. In effect, the concept of tax expenditure as used in this paper is the present value of all benefits associated with the operations of the Internal Revenue Code as applied over the 20-year life cycle of a rental residential project.

For the tenant-stockholders, the concept of tax expenditures is defined in an equivalent manner. In this case we compute the present value of all after-tax housing payments made over the 20-year period of homeownership, denoting the result by PV(25%), PV(18%), PV(13%) or PV(11%), depending upon the project type investigated. We next repeat the procedure of a tenant-stockholder in zero percent tax bracket and again denote the result by PV(0%). For the new/conventional coop, for example, the difference PV(25%)-PV(0%) is the equivalent tax expenditure associated with tenant-stockholders in that type project over the same 20-year period. As opposed to the rental case, however, the effects of sale are indefinitely deferred.

Although the definition of tax expenditure for tenant-stockholders has been framed in the above manner so as to keep it parallel with the rental residential case, the method will, of course, yield the same result had the annual mortgage interest and real estate taxes paid each year in excess of $2,000 been discounted and summed over the equivalent 20-year period. For technical reasons, described below, it was much easier to compute the tax expenditure for the tenant-stockholders in the indirect manner prescribed, rather than by direct computation.

B. The REAP Model

The computer model utilized for the simulation of the 20-year project operations and the computation of all present values and tax expenditures was the Real Estate Analysis Program (REAP) model developed by Dennis Eisen & Associates. This model has evolved over a long period of time and has been used in various investigations of the impact of the Federal taxation of real estate upon investor yields by various divisions of the U.S. Department of Housing and Urban Development, the National Association of Realtors, the National Consumer Cooperative Bank, and several major mortgage banking and real estate investment organizations. The model contains provisions for multiple ownership of real estate investments and produces reports at both the partnership and individual investor levels. Multi-year construction periods, partial first year operation, arbitrary apportionment of benefits and losses among partners, equity participation and adjustable rate mortgages, periodic refinancing, time-phased contributions to capital, downstream rehabilitation, etc., are all standard features of the model. The REAP model, of course, incorporates all major provisions applying to real estate investment contained in the Economic Recovery Tax Act of 1981.

By using the multiple ownership feature of the REAP model, the number of computer runs necessary to produce the results was cut in half. In each instance, two investors or two tenant-stockholders were presumed to own or occupy the project considered. In the case of rental properties, the first owner was placed in a 50% tax bracket and the second owner in a zero percent tax bracket. The difference in their present values, when multipled by a factor of 2.0 (because each owned half) was the desired tax expenditure sought.

The same procedure was utilized in the case of tenant-stockholders. To adopt the model so it represented the economic situation of the tenant-stockholders, the gross income was set to $2,000 (representing the zero bracket amount offset in part by the deduction of interest and taxes) per unit, and the only expense beyond normal debt service was the real estate taxes (growing at 10% a year in all instances). The difference in present value between the non-zero tax bracket tenant-stockholders and tenant-stockholders and the zero tax bracket "partner," when also multiplied by the factor 2.0, was again the desired result.

IV. Results

When the above procedures were carried out, the eight numbers produced for the present value of the 20-year tax expenditures are as presented in the table below.

Table 1: Summary of the Present Value of 20-Year Tax Expenditures, Per Unit

				Tax Expenditure		Members'
Case	Constr.	Tenancy	Financing	Rental	Coop	Tax Bracket
1	New	Conv.	Mkt. Rate	$14,770	$17,370	25%
2	New	Low & Mod.	Tax Exempt	13,360	8,090	13%
3	Rehab	Conv.	Mkt. Rate	9,980	7,520	18%
4	Rehab	Low & Mod.	Tax Exempt	10,750	4,010	11%

From the above table, we note that in three out of four cases, the 20-year tax expenditures are substantially lower for the tenant-stockholders of the cooperative housing corporation than for the investor-owners operating the same project as rental residential property. In the case of the rehab'd low- and moderate-income coop with tax exempt financing, the tax expenditures as a coop are only 37.3% of the corresponding tax expenditure if the project were operated as rental property.

Only in the one instance of new, conventional, market rate housing would the tax expenditures as coop be comparable with and somewhat exceed the tax expenditures as rental property. As the construction of new, conventional, market rate rental units is virtually non-existent in today's financial environment, this particular comparison may be considered moot.

A final point to be made with respect to the tax expenditures presented in Table 1 is that they scale in an absolutely direct fashion with marginal tax bracket. Thus, if additional evidence were to indicate that the average marginal tax bracket among tenant-stockholders in new conventional coops was more like 20%, for example, the correct table entry would be obtained by multiplying the $17,370 figure by the factor 0.8 (i.e., 20/25).

In summary, the deductibility of mortgage interest and real estate taxes to tenant stockholders of cooperative housing corporations under Section 216 of the Internal Revenue Code in almost all instances will result in a significantly lower tax expenditure to the U.S. Treasury than had the same project been owned and operated as rental residential property.

Statement of David A. Hegg
Executive Director, Idaho Housing Agency

October 16, 1981
Public Hearings on Mortgage Subsidy Bonds
(S. 1348 and S. 1656)

before the
Senate Committee on Finance
Subcommittee on Taxation and Debt Management

October 22, 1981

Statement of David A. Hegg
Executive Director, Idaho Housing Agency

The Mortgage Subsidy Bond Act of 1980 has made it far more difficult for the Idaho Housing Agency to increase the supply of housing for low-income families through the issuance of tax-exempt mortgage bonds. Since the issuance of our Home Improvement Program Bonds in the fall of 1980, no bonds have been issued. Although we have diligently tried to work within the Act, our inability to issue bonds has been due, in large part, to some of the Act's rigid requirements. The amendments proposed in S. 1656 and S. 1348 would adjust the most burdensome provisions of the Act and remove a major impediment to continuing our housing assistance.

The Idaho legislature created the Idaho Housing Agency by statute in 1972 and, by the terms of the statute, authorized the Agency to issue bonds to provide housing for persons of low income. The Idaho Housing Agency is an instrumentality of the state and the state legislature has authorized a continuing appropriation from the Idaho state sales tax account to the extent, if any, necessary to restore any deficiency in the capital reserve funds which are established out of the process of the bond issues. The Agency has undertaken a sustained and systematic approach to providing decent housing for Idaho's low-income citizens. In furtherance of this effort, the Agency has issued single-family mortgage purchase bonds, from time to time, under a bond resolution adopted March 1, 1978. In 1980, the Agency issued Home Improvement Program Bonds to make housing in the state decent, safe, sanitary and energy efficient. The Idaho Housing Agency is also active in the administration of several federal housing subsidy programs.

The bills under consideration, S. 1656 and S. 1348, would restore the Idaho Housing Agency's ability to increase the supply of housing for low-income families while retaining the Act's mandate to subsidize housing only in those areas of greatest need. S. 1656 and S. 1348 would amend the single-family provisions of the Act in four major respects. First, S. 1656 and S. 1348 would raise the permitted arbitrage spread between the bond yield and the interest rate on the mortgages. The Idaho Housing Agency is self-supporting. Its costs are paid from fees for administering housing subsidy programs and from fees and interest earnings on the financing of housing programs. By increasing the arbitrage limitation in the minimal amount proposed, S. 1656 would permit the Idaho Housing Agency to continue to generate enough funds to meet the cost of issuing bonds and operate housing programs that are self-sustaining and self-supporting and cause no tax burden to the citizens of Idaho.

The second major change proposed by S. 1656 and S. 1348 would be amendment of the 95% actual compliance provision of the Act. The present law provides that 95% of the proceeds of an issue must be invested in loans that comply with all of the eligibility requirements (residency, prior ownership and purchase price) in order for the entire issue to qualify for tax-exemption. Under present law, even if a good faith effort to comply is made, if at any time more than 95% of the loans do not meet these complex criteria, then the issue may become taxable retroactively. S. 1656 provides that any requirements not met at the time of execution, would be treated as having been met if it is corrected or "diligent" efforts are made to correct it. The bill would also amend this provision to require issuers to periodically audit and prosecute fraud cases. S. 1348 would eliminate the 95% compliance provision and allow bond holders to rely on a covenant by the issuer that it has made a good faith effort to comply. Under the Idaho Housing Agency programs, the Agency purchases loans originated by banks, trust companies, life insurance companies, building and loan associations, and other financial institutions authorized to transact business within the state of Idaho. The participation of several kinds of lending institutions in the program makes the low interest programs more accessible to residents. In programs like ours, where loans are originated by a variety of lenders, a 5% margin of error is unrealistic. The threat of falling even slightly short of 95% compliance under the present law, subjects an entire issue to retroactive taxability and effectively chills any good faith efforts of the Agency to conform to the law. In fact, institutional buyers, who comprise about half of the bond market, will not purchase mortgage revenue bonds because of the 95% compliance provision and the threat of taxability. The safeguards of periodic audits and prosecution of fraud cases would effectively prevent abuses without jeopardizing an entire bond issue where diligent efforts are being made to comply. Furthermore, a covenant of good faith would give bondholders and investors reassurance that the bonds would not become taxable.

The third major change included in both bills would be the elimination of the burdensome registration requirement of the Act. The present law provides that in order for bonds to qualify for tax-exemption, each obligation must be issued in registered form. This registration requirement drastically increases borrowing costs and adds unnecessarily to paperwork. The registration of mortgage bonds would set them apart from all other tax-exempt bonds and create a two-tiered market: one for registered mortgage bonds and another for all non-registered bonds. The development of a market structure to accommodate the registered bonds will be costly and cumbersome, further diminishing the marketability of mortgage bonds.

Finally, under either S. 1656 or S. 1348, issuers would not be required to sell investments held in reserve at a loss. Under the present law, issuers may be required to lose more from selling investments than they have received and accumulated as arbitrage profits. The bill would not change the present requirement that net arbitrage (arbitrage profits less any losses from sales of non-mortgage investments) must be rebated to mortgagors or the federal government.

In addition to these four major changes in the Act, S. 1348 would make additional amendments to the single family provisions of the Act that would benefit Idaho residents. In order to qualify under the present residency requirements, a mortgagor could not have owned a principal residence within the last three years. S. 1348 would permit mortgagors to qualify who live in substandard housing, or in residences which are not habitable because of natural disaster or governmental action. With this important change, the Idaho Housing Agency would not be prevented from assisting individuals whose only ownership interest has been in a substandard or uninhabitable dwelling. S. 1348 would allow two or more qualified mortgage issues of a single issuer to be treated as a single issue for purposes of compliance. Where bonds are issued under a continuing resolution, as is the case in Idaho, this change would facilitate lower administrative and issuance costs. The bill would also redefine areas of chronic economic distress to include areas designated by the state (not to exceed 25% of the geographical area within a state) and eliminate the requirement that a designation be approved by Treasury and HUD. In addition, the bill would add "energy impacted areas" to the targeted areas.

Mobile homes would be excluded from average purchase price computations and these computations would not have to be recalculated more than twice a year. This change would allow more equitable and efficient determinations of average area purchase price in Idaho. Finally, S. 1348 would make technical adjustments in the yield computation rules.

S. 1656 would make changes to the multifamily provision of the Act. Since 1977, the Idaho Housing Agency has issued $63,665,000,in Insured Section 8 Assisted Housing Bonds, to finance various multifamily developments. Present law requires that 20% of rental property be occupied by low or moderate income (Section 8 eligible) individuals for 20 years. The present occupancy requirement raises obvious problems of guaranteeing future compliance by occupants of subsidized homes. S. 1656 would reduce the 20 year occupancy requirement to the longest of 10 years, half the term of the bond issue, or the term of the subsidy. This change would add an important degree of certainty to the future of a residence that initially qualifies under the law. Futhermore, under S. 1656, the definition of low income would not be tied to future amendments in the Section 8 subsidy program.

The Idaho Housing Agency continues to work diligently toward the goal of providing more housing funds for Idaho's low income citizens. In their behalf I strongly urge you to support passage of the amendments proposed in S. 1656 and S. 1348. The changes proposed by S. 1656 and S. 1348 would allow the Idaho Housing Agency to continue its efforts to provide an adequate housing supply for low income families and help spur a badly ailing lumber and housing industry in this state.* The bills leave the main thrust of the Mortgage Subsidy Bond Act intact, have no negative effect on federal budget assumptions and maintain the intent of the Act by targeting housing bond funds to those in the greatest need. Thank you for giving me this opportunity to express my views.

DAH:lmb
8-9
6-6

*From 1979 (1) Idaho contract and construction employment is down 18%

(2) Lumber and wood products employment is down 20%

(3) Housing starts have decreased 48%

Statement of the Public Securities Association

The Public Securities Association welcomes the opportunity to submit its comments on S.1348 and S.1656, both of which have been introduced to correct technical shortcomings in the Mortgage Subsidy Bond Tax Act of 1980. PSA represents brokers, dealers, and dealer banks active in the public fixed income securities markets. We currently have nearly 300 regular members, whose offices are located in all 50 states. Last year our members participated in over 95% of the dollar volume of new issues of state and local government bonds.

It has been well documented that at this time our Nation is in the throes of a severe housing crunch. In an effort to help moderate the effect of this state of affairs on low and moderate income families Congress enacted the Mortgage Subsidy Bond Tax Act of 1980. Congress intended that the Act facilitate, subject to certain limitations, the issuance of mortgage revenue bonds to provide residential mortgage loans for low and moderate income families. It is clear however that the Act together with the Temporary and Proposed Regulations issued by the Department of the Treasury and the Internal Revenue Service will permit the issuance of very few, if any, mortgage revenue bonds. Consequently, we support Congressional efforts to correct technical deficiencies that contravene the original intent of the Congress. We believe that both S.1348 and S.1656 are appropriate vehicles to achieve that end.

I. The Need For Viable State and Local Government Mortgage Revenue Bond Programs

Sales of new and existing homes continue to lag badly. Figures released by the Commerce Department reported that gross single family housing starts in September stood at an annualized rate of 900,000 units,approximately 50% of the rate of January 1981. Data from the National Association of Home Builders further revealed that for the first half of 1981 annualized gross housing starts numbered barely half the starts of 1978. Moreover, the National Association of Realtors reported that September sales of existing single family homes had declined to their lowest level in 5½ years. They reported that September 1981 sales were 37% below the rate of September 1980.

Further, the cost of housing finance continues to reach unprecedented levels. On October 1, 1981 the Federal Home Loan Mortgage Corporation announced that the average weighted yield of fixed rate mortgages accepted under their weekly purchase program had reached a record level of 18.917%. Although high mortgage rates have moderated slightly the increase in single family home purchase prices,the average cost of a new home now stands at approximately $67,000. Moreover, builder carrying costs--nearly 20% nationally--on construction loans and completed but unsold homes may inhibit future home construction.

At the same time, however, The Daily Bond Buyer for August 31, 1981, reported that only one single family issue subject to the permanent restrictions of the Act has been publicly marketed, and that issue was substantially reduced in size by virtue of the regulatory restrictions. The volume of all housing bonds issued in the third quarter of 1981 declined 71.6% from the volume in the third quarter of 1980. Thus, at a time when home sales have declined significantly and financing costs continue at peak levels,state and local government mortgage bond programs are being severely restricted by Federal actions.

II Congress Intended That The Mortgage Subsidy Bond Tax Act of 1980 Improve the Efficiency of Tax-Exempt Financing for Housing, Not Eliminate Such Financing

The severe diminution in the issuance of mortgage bonds, discussed above,clearly was not an intended result of the Act. In 1980, the House Ways and Means Committee approved legislation restricting mortgage revenue bonds. That legislation was subsequently enacted with some minor modifications as section 103A of the Internal Revenue Code. Unfortunately, the legislation was never fully considered by the Senate Finance Committee or the full Senate prior to its enactment. The report of the Ways and Means Committee (H.R. Rep. No.96-678, 86th Cong. 2d Sess.) states as follows:

> "...The Committee believes that restrictions should be placed on the use of tax-exempt bonds for housing that will direct the subsidy to those families and areas most in need of the subsidy, that will improve the efficiency in using tax-exempt bonds for housing, and that will limit the revenue loss."(emphasis added).

Even the statements of the Committee regarding establishment of a review process to determine the efficacy of the Act's provisions make clear the Committee's intent to base its review on whether viable state and local government mortgage revenue bond programs have been conducted in accordance with the provisions of the Act. The report of the Committee notes that the review mechanism was intended,

> "...to permit the Committee to reexamine the results and the need for the program within a relatively short period of time."

The same theme was expressed by Conferees from the House and the Senate in Title XI of the Conference Report on the Omnibus Reconciliation Act of 1980, which added section 103A to the Tax Code. A review of the financial projections of both tax writing Committees provides further evidence that Congress intended to create a viable mortgage bond program under the Act. In "Estimates of Federal Tax Expenditures for Fiscal Years 1981-1986," a report prepared by the staff of the Joint Committee on Taxation for the Committees of Finance and Ways and Means and released March 16, 1981, budgetary projections were drafted which contemplated that a substantial number of mortgage bonds would be issued.

The legislative history demonstrates clearly that Congress believed (1) that there was a need for meaningful state and local government housing programs funded through mortgage revenue bonds and (2) that the Act had been drafted to enable the programs to function well enough so that a reasonable review of the programs could be conducted by 1983. However, the complexities of the municipal securities market in combination with overly restrictive Proposed and Temporary Regulations have prevented the Act from achieving the intent of Congress. Adoption of the bills now before the Subcommittee, we believe, will enable the Act to meet its intended purpose of assuring continued state and local government housing programs.

III. The Act As Drafted and The Temporary and Proposed Regulations Will Permit the Issuance of a Minimal Volume of Mortgage Revenue Bonds

In spite of the intent of Congress that mortgage bond programs proceed, certain provisions in the Act and their interpretation in the Proposed and Temporary Regulations have virtually repealed the mortgage bond exemption. Due to the exigencies of the municipal securities market certain provisions in the Act work at cross-purposes with the intent of the Congress. Further, as stated in our comments to the Honorable Roscoe L. Egger, Jr., Commissioner of the Internal Revenue Service, the interpretation of the Act in the Regulations is generally inconsistent with the Congressional intent. A copy of our comment letter is included herewith and we request that it be included in the record.

The statute sets forth a number of requirements which must be met for a mortgage bond issue to be tax exempt. Certain of the requirements under section 103A (c)(2)(B) necessitate a conclusion that;

> "95% percent or more of the proceeds devoted to owner-financing was devoted to a residence with respect to which (at the time the mortgages were executed) all such requirements were met."

A strict reading of this provision could lead to the result that, regardless of the safeguards built into the program or subsequent corrections made, if at any time there are more than 5 percent in nonqualifying mortgages the bonds will be considered taxable from date of issuance. This is the position taken in the Treasury Regulations. As currently construed in the Regulations this provision has prevented bond counsel from issuing unqualified tax opinions that the interest on the mortgage bonds is tax exempt. Unqualified tax opinions are required to place the bonds with investors in tax-exempt securities. Consequently, until such time as the interpretation of this provision is changed it is unlikely, in our opinion, that any significant volume of mortgage bonds can be issued.

Additionally, we believe that the provisions in both the Act and the Regulations regarding allowable yield on the investment of bond proceeds have further curtailed the feasibility of state and local government mortgage bond programs. In addition to the overly restrictive provisions concerning allowable yield, other limitations in the Act and Regulations disallow the six month convention for mortgage prepayments and treat fees from mortgage originations as yield on non-mortgage investments. These provisions reduce the internal cash flow available to help finance mortgage bond programs. The combination of the 95 percent requirement and these yield restrictions has devastated mortgage bond programs.

It has been our hope that the Regulations would have been drafted in a manner which would have allowed for the issuance of a reasonable amount of single family mortgage revenue bonds as envisioned by the Congress. However, as noted above, and in our comment letter to the Service, the Regulations inhibit the issuance of the bonds and exacerbate efforts of issuers and underwriters to structure marketable tax-exempt mortgage bond issues. Since the Service and Treasury have been unable to issue workable Regulations based on the Act as currently formulated we can only conclude that the Act should be amended.

IV. Conclusion

The housing statistics set out above clearly demonstrate the need for viable state and local government housing programs for low and moderate income families. However, as we have seen, the Act and the Regulations for all intents and purposes have prohibited states and local governments from using mortgage revenue bonds to finance these programs. Thus, unless the Act is amended we believe that state and local government housing programs cannot function effectively. We are heartened, however, that this Subcommittee has deemed it appropriate to reexamine the Act and consider bills designed to correct its shortcomings. We urge you to support these bills.

Public Securities Association
One World Trade Center
New York, New York 10043
(212) 466-1900

PSA

August 31, 1981

The Honorable Roscoe L. Egger, Jr.
Commissioner of Internal Revenue
Internal Revenue Service
Washington, D.C. 20224

Attention: CC:LR:T (LR-10-81)
Proposed Regulations Under the Mortgage
Subsidy Bond Tax Act of 1980

Dear Commissioner:

The Treasury Regulations Committee of the Public Securities Association wishes to express its concern about the effects of the Proposed Single Family Mortgage Subsidy Bond Regulations issued pursuant to the Mortgage Subsidy Bond Tax Act of 1980 (the Act), and to recommend certain changes in the Regulations. PSA is the national trade association representing banks, dealers and brokers that underwrite, trade and sell state and local government securities.

In our view, the approach taken by the Department of the Treasury and the Internal Revenue Service in drafting the Proposed Regulations does not reflect the stated intent of Congress in adopting the Act. The Committee believes that these Regulations could have been drafted in accordance with the provisions of the Act and yet permit the financing of a reasonable number of residences for low and moderate income families as intended by the Congress. Instead, the Regulations as currently drafted, will permit very few, if any, single family housing bonds to be issued. And, therefore, the Congressional intent has been nullified by regulatory action.

Moreover, we are troubled that the Service and the Treasury have chosen to adopt such a restrictive policy towards state and local government borrowing practices at a time when these levels of government are being asked to shoulder a larger share of the responsibility of providing for the needs of their citizens. In announcing the formation of the Presidential Federalism Advisory Committee, President Reagan clearly defined his position relative to the realignment of the duties and obligations of the several levels of government when he stated:

> We need to provide for greater authority and responsibility in the states, counties, cities and towns--to return government to those closest to the people most affected.

We therefore believe it critically important that the federal government not further restrict the right of state and local governments to meet the needs of their citizens at a time when so many responsibilities are being returned to state and local levels of government.

I. Section 103A is Intended to Improve the Efficiency of Tax-Exempt Financing for Housing, not to Eliminate Such Financir

Federal tax law necessarily must be construed in light of the Congressional purpose in enacting the statute. In 1980, the House Ways and Means Committee approved legislation restricting mortgage revenue bonds, and that legislation was subsequently enacted with modifications as section 103A of the Internal Revenue Code. The report of the Committee (H.R. Rep. No. 96-678, 86th Cong. 2d Sess.) states as follows:

> ...The Committee believes that restrictions should be placed on the use of tax-exempt bonds for housing that will direct the subsidy to those families and areas most in need of the subsidy, that will improve the efficiency in using tax-exempt bonds for housing, and that will limit the revenue loss. (emphasis added)

Indeed, even the statements of the Committee regarding establishment of a review process to determine the efficacy of the Act's provisions make clear the Committee's intent to base its review on whether viable state and local government mortgage revenue bond programs have been conducted in accordance with the provisions of the Act. The report of the Committee notes that the review mechanism was intended,

> ...to permit the Committee to reexamine the results and the need for the program within a relatively short period of time.

The same theme was expressed by Conferees from the House and the Senate in Title XI of the Conference Report on the Omnibus Reconciliation Act of 1980, which added section 103A to the Tax Code. A review of the financial projections of both taxwriting Committees provides further evidence that Congress intended to create a viable mortgage bond program under the Act. In "Estimates of Federal Tax Expenditures for Fiscal Years 1981-1986," a report prepared by the staff of the Joint Committee on Taxation for the Committees of

Finance and Ways and Means and released March 16, 1981, budgetary projections were drafted which called for a substantial number of mortgage bonds to be issued.

This legislative history demonstrates quite clearly that Congress believed that there was a need for meaningful state and local government housing programs funded through mortgage revenue bonds, and that the programs should be able to function well enough that a reasonable review of the program could be conducted by 1983.

II. The Proposed Regulations Frustrate the Purpose of Section 103A

The Committee believes that unless the Proposed Regulations are substantially modified, their effect will be a virtual repeal of the mortgage bond exemption. As stated earlier, this result is inconsistent with the intent of Congress to allow the financing of state and local government housing programs to continue in a more efficient manner.

There continues to be a serious need for state and local governments across the Nation to provide mortgage financing for single family residences for low and moderate income families. As you are no doubt aware, new housing starts continue to lag and financing costs continue to soar. Figures released by the National Association of Home Builders reported that for the first half of this year, gross housing starts stood at an annualized level of 1,032,000 units as compared to the 2,036,000 housing starts in 1978. Further, on August 27, 1981, the Federal Home Loan Mortgage Corporation announced that the average weighted yield of fixed-rate mortgages accepted under their weekly purchase program rose to a record 17.663%. At the same time, however, The Daily Bond Buyer for August 31, 1981, reported that only one single family issue subject to the new restrictions of section 103A has been publicly marketed, and that issue was substantially reduced in size by virtue of the regulatory restrictions. The present need for mortgage revenue bond financing is indisputable, however, as a result of the posture taken by the Service in drafting the Proposed Regulations, we do not believe that the intent of Congress to improve the efficiency of mortgage revenue bond programs is being given effect.

III. Principal Areas Where the Proposed Regulations Should be Modified

PSA recognizes that while regulations under section 103A must reasonably interpret the language of the Act, the statute can and should be construed in a manner more consistent with the expressed Congressional intent to strengthen and improve the efficiency in using tax-exempt bonds for housing.

A. The 95 Percent Requirement

The statute sets forth a number of requirements which must be met for a debt issue to be a qualifying tax-exempt mortgage bond issue. With respect to certain of the requirements, section 103A(c)(2)(B) requires a determination that:

> 95 percent or more the the proceeds devoted to owner-financing was devoted to residences with respect to which (at the time the mortgages were executed) all such requirements were met.

Under the most restrictive interpretation of this language, bonds issued for a particular program which at any time had more than 5 percent in non-qualifying mortgages, would be taxable upon issuance--and no subsequent event could change that result. This would be true even in cases where the issuer either had no reason to suspect the defect or, having knowledge of the defect, would be able correct it by substituting qualifying mortgages.

As proposed, the Regulations do not indicate that this most restrictive intepretation is incorrect. Yet, the substantial uncertainty resulting from such interpretation is now preventing issuance of unqualified tax opinions, required in the marketplace, that the interest on mortgage bonds is tax-exempt. In view of the Congressional intent that there be an efficient and meaningful mortgage bond program, we believe this uncertainty overhanging the market must be dispelled.

The Proposed Regulations can and should be modified to provide a procedure which may be relied on to establish that mortgage bonds are - and will remain - tax-exempt. The Regulations could require that relevant documents specify general steps for verifying that the statutory tests are met. The Regulations could also provide examples of documents to be obtained in this connection. Further, approval of each mortgage could be conditioned on the mortgagor's filing a certificate as to compliance with the Act's requirements, and written notification to the mortgagor that under state law, any falsification of the certificate is a punishable offense.

Finally, as contemplated by the statute, any failure to meet the requirements listed in section 103A(c)(2)(B) would have to be corrected within a reasonable period after it is discovered. If an issuer adopted procedures, certifications and requirements of this nature as called for by regulation, this would provide an adequate basis to establish that mortgages are qualifying when executed, and the Regulations could so provide. In this manner, the Congressional intent that there be some efficient and meaningful mortgage bond program could be achieved.

B. Yield and Investment Provisions

The legislative history shows that the basic Congressional purpose in enacting section 103A was not to prevent issuers from earning arbitrage profits on investments of mortgage bond issue proceeds. The new statutory provisions do contain certain specific arbitrage limits (e.g., the 1 percent ceiling and the requirement that all arbitrage profit on non-mortgage investments must ultimately be rebated). The statute and Committee reports specify that, in addition to compliance with section 103A, mortgage bonds must also meet the requirements of section 103(c). Thus, Congress dealt specifically with arbitrage only in certain areas. Otherwise, Congress simply intended that the general limitations in section 103(c) would apply.

We believe that a number of provisions in the Proposed Regulations which are not set out in the Act will reduce the feasibility of many state and local government mortgage bond programs. (e.g., disallowance of the six-month convention for mortgage prepayments, the treatment of fees from mortgage originators as yield on non-mortgage investment, and the one year limit on the period during which bond proceeds may be invested without yield restrictions pending delivery of mortgages. The Committee believes that the Regulations should apply the general limitations of section 103(c) to all situations regarding arbitrage restrictions not specifically addressed in section 103A.

IV. Conclusion

The Service recently announced its intention to hold a hearing on the Proposed Regulations on November 5, 1981. We believe that it is inappropriate to hold the hearing more than two months after the close of the comment period and nearly a full year into a three year period established for Congressional review of state and local programs conducted pursuant to the Act and its Regulations. We urge the Service to adopt a more expeditious schedule for the hearing in order to provide for the issuance of Final Regulations within a reasonable period of time.

As stated above, our Committee believes that the Proposed Regulations do not reflect the intent of Congress that state and local government mortgage bond programs go forward. However, if the Service and Treasury believe that the provisions of the Act preclude the issuance of workable Regulations, we believe that the Treasury should support the adoption of meaningful amendments to the Act--such as H.R. 3614 and S. 1348--which will allow the Act to meet the objective of Congress of improving the efficiency of state and local government single family housing programs funded through mortgage revenue bonds.

Sincerely yours,

Francis X. Coleman

Francis X. Coleman
Chairman
Treasury Regulations Committee

FXC:sc

cc: The Honorable John E. Chapoton

adoptive couples together
a non-profit organization

9500 Abel Lane
River Ridge, LA 70123

(504) 737 - 2008

October 12, 1981

Senator Russell Long
United States Senate
Room G 204 Dirksen Senate Office Building
Washington, D.C.

Re: Committee on Finance
Subcommittee on Taxation and Debt Management
Hearing: October 16, 1981, 9:30 AM Room 2221 Dirksen Office Building
Senate Bills S608, S 1479, S1580

Dear Senator Long:

Adoptive Couples Together, Inc. (ACT) is an organization of adoptive and prospective adoptive parents in the metropolitan New Orleans area. Founded in 1973, ACT has maintained an active membership of approximately one hundred families as well as honorary members and representatives of many adoption and child caring agencies in Louisiana. Additionally, ACT is a member of the North American Council on Adoptable Children, the National Committee for Adoption, and the New Orleans Association of Maternity Homes and Adoption Agencies.

We became aware recently of the above referenced bills which deal with tax deductions, exemptions, and credits for adoption fees and expenses. At present, families who grow through adoption are discriminated against by tax laws which allow deductions for expenses incurred in expanding families through birth but do not allow deductions for the same expenses when related to adoption. Additional financial burden is placed on the adopting family since most medical insurance plans do not cover medical expenses related to the birth of an adopted child.

We are, therefore, taking this opportunity to voice our wholehearted support for any or all of the above referenced bills and we respectfully request that you vote favorably on them.

While we support all of these bills, the one authored by Senator Jepsen (S1580) is, we believe, particularly comprehensive and socially significant because of the incentives it provides for the adoption of handicapped, older, and/or minority children. With the number of legally adoptable U.S. children with these special needs numbering more than 100,000, anything that will make their adoption easier should be strongly considered and, where fiscally possible, should be made law.

We thank you for your consideration of this matter and we trust that you will act positively to bring about the tax revisions proposed by these bills.

Sincerely,
Ashton and Royann Avegno
Ashton and Royann Avegno
Chair
ACT Committee on Adoptable Children

Copies:

Members of the Subcommittee on Taxation and Debt Management
Mr. Robert E. Lighthizer
National Committee for Adoption

Record 11th.

SUBMITTED STATEMENT OF THE
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS
TO THE SENATE FINANCE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT ON
S. 1348 AND S. 1656, BILLS THAT WOULD AMEND THE
MORTGAGE SUBSIDY BOND TAX OF 1980

November 3, 1981

The AFL-CIO welcomes the opportunity to submit for the record its views on S. 1348 and S. 1656, bills that would amend the Mortgage Subsidy Bond Tax of 1980. We are generally opposed to both bills.

S. 1348

Sections 1(a) and 1(b) would amend the present statutory requirement for a good faith effort to comply with mortgage eligibility requirements. The eligibility requirements are designed to assure that the proceeds of authorized tax-exempt bond issues are used to finance the principal residences of the mortgagors within the jurisdiction of the authority issuing the bonds; that bond proceeds are not used to help a person who owns a home to purchase a new one with a subsidized mortgage; and that the proceeds are not used to finance the purchase of a home whose price exceeds 90 percent of the average purchase price in the area. If all these requirements are met by the new homeowner, the mortgage may be assumed.

Under the Act, where good faith in meeting the aforementioned requirements has been exercised, 95 percent or more of the lendable proceeds must have been invested in mortgages meeting all of the requirements at time of execution of the mortgages.

Section 1(a) and 1(b) would greatly relax the present (95 percent) good faith requirement by excusing the issuer if he in good faith attempted to meet all requirements before the mortgages were executed and corrected the failure to meet the requirements within a reasonable period after the failure was first discovered.

The objections to this proposed amendment are twofold: First, the present requirement is that only 95 percent of the mortgages made with the proceeds of the bond issue have to meet the various requirements as to mortgagors and residences. Thus, there is a 5 percent leeway; and if good faith is exercised, it is unlikely that there should be more than a 5 percent error.

Secondly, if the house has already been sold, although the mortgage has not been executed, when failures are discovered, it becomes very impractical to correct since the prospective home buyers have in good faith made deposits and signed sales contracts.

In Section 1(c) on previous ownership interest in a home, certain exceptions would be made against mortgage lending to persons who had an ownership interest in a residence during the past three years. That would be with respect to prior residences which would be certified by a state or local official as not meeting minimum standards established by the state or local government, or owners who had an ownership interest in a prior residence that cannot be occupied on a permanent basis due to a national disaster to governmental action. The latter point, when a residence has been made uninhabitable, is acceptable. However, when it comes to certification by state or local officials that the prior residence did not meet minimum property standards that could have been established by local areas, that should not be made acceptable. It is not appropriate to permit a local area to establish a very high minimum property standard and to allow that to become the grounds for local persons to receive subsidized interest rate mortgage loans to purchase new homes.

Section 1(d) would modify the statute with respect to determination of the average area purchase price in several ways. One of these modifications would permit separate determinations of average area prices for (a) residences which have not been previously occupied and (b) residences which have been previously occupied. This modification should not be approved since it would be contrary to the original intent of a price restriction to act also as a restriction against having tax-exempt mortgage benefits going to higher income home purchasers. It should be recalled that the legislation to restrict mortgage revenue bond issuances was prompted by abuses in localities where benefits went to high income home buyers. A separate average price calculation for new homes, which generally have higher sales prices than previously occupied homes, would cause higher priced homes to be financed for higher income buyers than under the present statute.

Section 1(e) deals with the effective mortgage rate. Subparagraph (A) of this section would permit a spread of 1.5 percentage points to cover the cost of issuing the bonds. The present limitation of 1 percent has been adequate; all issuing authorities have been able to find issuers who apparently find it worth their while. There is no reason for authorizing increased yields which would require high debt service and higher mortgage or rental payments, thereby defeating the purpose of providing housing for moderate-income people.

Section 1(h) on program compliance, under subparagraph (A), would permit two or more qualified mortgage issues to be treated as a single issue for the purposes of determining compliance. The two issues (in a state) may actually be in two widely separate and different market areas in which one would be at an advantage and the second at a disadvantage through combined treatment for compliance.

Section 1(i) would be exempt from certain compliance requirements, including the purchase price and arbitrage limitations, the mortgages which are insured by FHA or guaranteed by VA that are being assumed. There is no reason for such exemptions which would permit sales prices above the basic statutory limits.

S. 1656

The bill proposes several changes in the Revenue Adjustment Act of 1980, Public Law 96-499.

First, the present 95 percent good faith requirement could be ignored with respect to a bond issue under the Act if periodic audits were conducted and any cases of fraud would be prosecuted. This proposal mixes apples and oranges. The purpose of the good faith requirement is to see that the proceeds of authorized bond issues are used for principal residences of the mortgagors within jurisdiction of the authority issuing the obligation; that it is not used by a person who owns a home to purchase a new one with a subsidized mortgage; that it is not used to finance high-priced homes exceeding 90 percent of average area purchase price. The purpose of these provisions is separate from the question of fraud to be detected by audits, against which any issuing authority presumably would take precautions.

Under the second proposed provision, the user would be allowed a 1.25 percent yield to cover the cost of issuing the bonds. The present limitation of 1 percent has been adequate; all issuing authorities have been able to find issuers who apparently find it worth their while. There is no reason for authorizing increased yields which would require high debt service and higher mortgage or rental payments, thereby defeating the purpose of providing housing for moderate-income people.

Another proposed change would call for removal of the registration requirement on the grounds that no other tax-exempt bonds face this requirement. That is no reason not to have a registration requirement for this special-purpose type of bond issue. It is important to be able to trace the ownership of the bonds after issue to help detect if there is any collusion between residential developers, local authorities, and subsidized mortgage recipients, any one of whom might be bond buyers.

The two technical changes under the last proposed amendment, dealing with eligible rental housing, should be supported. One would set the lower income occupancy requirement at 80 percent of area median income, and the other would call for a relatively long-term, moderate-income occupancy requirement which would be tied to the term of the subsidy or a longer term, thus encouraging longer terms for low-income occupancy and also longer term financing which would be healthier for continuation of rental housing.

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Anthony M. Frank
Chairman and President

October 15, 1981

Honorable David Durenberger
United States Senate
Washington, D.C. 20510

Dear Senator Durenberger:

I am writing to you to express my support of the use of Tax Exempt Mortgage Revenue Bonds for housing and my deep concern over the present status of Mortgage Revenue Bonds under the Mortgage Subsidy Bond Tax Act of 1980. H.R. 3614 and SB 1650 deal with some of the problems with which I am concerned.

Not since the depression has this country faced a housing crisis as severe as the one we are facing today. With conventional long term fixed rate financing virtually disappearing, and with available financing carrying variable interest rates at 16% - 17% with short terms, younger families in the low, moderate and middle income groups have been effectively shut out of the housing market. Construction starts are drastically down, demand is higher than ever in most areas of the country, and there is virtually no vacancy factor in rental housing. No new rental projects are being built and many communities are becoming gravely concerned that their economic industrial base will erode because the employees needed to work in these businesses cannot find shelter in the surrounding communities.

Since 1977, one of the few viable solutions in this crisis has been the introduction and growth of Tax Exempt Mortgage Revenue Bonds. The Mortgage Subsidy Bond Tax Act stopped the potential for unlimited growth of such financing which so gravely concerned the Treasury. However, in drawing up guidelines for the use of Tax Exempt Housing Bond financing, the staff of the House of Representatives put provisions into the Act that made it virtually impossible for communities to go forward with new bond issues.

My Association, since 1977, has actively participated with communities all over California by originating and servicing loans under their bond programs, most of it badly needed new construction. We would like to continue but the Act makes it impossible.

Let me highlight the major problems and recommend changes in the Act that, I believe, can resolve the problems, avoid abuses and allow these bonds to be issued for sorely needed housing within the broader limits of the Act:

1. Problem - Arbitrage limits of 1% between bond yield and the mortgage rate do not allow for realistic costs to be absorbed. Mortgage loan originator-servicers have typically agreed to originate these loans for fees of 1% of the loan, and service the loans for 3/8ths of 1% per year. This fee structure is generally recognized to be a reasonable return in the Mortgage Banking Industry. FNMA and FHLMC both recognize this. If anything, bond programs put additional unique requirements on the originator-servicer. Present arbitrage limits do not allow for standard 1% origination and 3/8ths servicing fee.

   Solution- Change the Act to allow for origination and servicing fees which are not calculated in the arbitrage spread so long as they are not in excess of those typically allowed or paid by FNMA or FHLMC to seller-services.

2. Problem- The Act has taken the responsibility for non-compliance by the mortgagor from the mortgagor and put the consequences of such non-compliance on the bondholder by making the bonds taxable if more than 5% of an issue is found to be used by ineligible mortgagors. The effect of this provision is to make such bonds uncompetitive or unissuable in the market by virtue of an unwarranted risk to the bond investor on his expected effective yield.

Further, any responsible financial institution originating and servicing these loans is faced with an unreasonable business risk because of the potential for having to defend itself against bondholder suits. My association has and will be willing to assume liability for properly documenting a loan package and obtain relevant certification by agreeing to repurchase such loans, should such loans not be properly documented. However, we cannot assume the risk inherent in a bondholder's suit for actions of a Mortgagor who has signed all the relevant certifications and has done so fraudulently.

Solution- Amend the Act to allow the Bond Issuer, Originator-Servicer, and Bondholder to rely on Certifications of a Mortgagor as to those criteria required of him, namely:

a. Intent to occupy as primary residence.

b. Not a homeowner in past three years.

c. Purchase price is within prescribed limits and fully disclosed.

3. Problem - Any loan found not to comply with the above criteria must be corrected. In the case of fraud regarding ownership of a primary residence in the past three years or the purchase price actually exceeding the maximum allowed, the corrective action must be to remove the loan from the bond program. This, as a practical matter, means that the originator-servicer would have to repurchase a sub-market rate loan at par. Repurchasing just a few of these loans would wipe out a years' servicing income despite the best efforts of an originator to properly document the applications of mortgagors.

Solution- Allow loans, where the mortgagors are determined not to have met the eligibility criteria despite having executed relevant certifications, to remain in the bond program subject to the following conditions:

1. The Promissory Note is written at a market rate (perhaps FNMA) with an agreement to accrue interest at the bond program mortgage rate.

2. The Agreement provides that should the initial mortgagors or subsequent purchasers using the bond financing be determined at anytime to be ineligible under the criteria previously described, the interest rate would accrue at the higher note rate.

3. Should such higher rate be triggered, the difference between the bond program mortgage rate and the higher note rate would be paid to the Federal Government.

4. Failure by the mortgagor to make monthly payments at the higher note rate once ineligibility has been determined, would result in default, acceleration of the loan and foreclosure, should the mortgagor fail to pay off the loan on demand.

I believe that the changes I have described are workable and fair. The responsibility of misuse is put where it belongs, on the person(s) who abuse the program the mortgagors. The Federal Government could be reimbursed for an improper use of what is essentially a Federal subsidy while the bondholder, issuer and loan originator-servicer are protected against those risks outside of their control.

I support and urge any legislation that would result in these changes to the Mortgage Subsidy Bond Tax Act of 1980.

Sincerely,

Anthony M. Frank
Chairman and President

To be part of the Hearing Record of October 16, 1981. The above signed is also Chairman of the California Housing Finance Agency.

OFFICE OF THE STATE TREASURER

CLAY MYERS
STATE TREASURER

FRED HANSEN
CHIEF DEPUTY

STATE CAPITOL
SALEM, OREGON 97310
378-4329

WRITTEN TESTIMONY PREPARED FOR THE
SENATE COMMITTEE ON FINANCE
BY OREGON DEPUTY STATE TREASURER FRED HANSEN
OCTOBER 29, 1981

Thank you for the opportunity to submit written testimony concerning the bond registration requirement which appears in the Mortgage Subsidy Bond Tax Act of 1980. Of particular concern to us in the Oregon Treasury, and of course to the State's Department of Veterans' Affairs, is the provision in the Act which extends the registration requirement to "Qualified Veterans' Mortgage Bond" programs. Most of Oregon's general obligation borrowing is done to finance farm and home loans through a program which, since 1945, has provided a significant benefit to both eligible veterans and the state's economy. We are very concerned that the costs associated with issuance of registered bonds will have a negative impact on this well established state program and on the programs administered by the state's Housing Division in the Department of Commerce.

Before moving to the specific impact of bond registration, allow me to state that the officials of the Oregon Treasury Department, the Housing Division and Department of Veterans' Affairs are well aware of the tax concerns which led to incorporation of the registration requirement in the original legislation. However, we are hopeful that your current review of the costs associated with registration will lead to consideration of remedial actions which bear less negative consequences for the municipal issuer while still addressing the concerns of the Administration.

I am sure that in the course of your deliberations you have heard various estimates of the interest rate penalty issuers of registered bonds will face. While it may be argued that no definitive estimate of additional cost can be made, it is undeniable that registration is a transaction cost -- and that transaction cost will be passed along to the issuer at the time of sale.

In Oregon we have had some recent experience with the issuance of registered bonds through our Alternate Energy Program. The requirement that these bonds be issued in registered form may be found in an amendment to the Crude Oil Windfall Profits Tax Act. The best estimates we have been able to derive from those experts closest to the marketing effort indicate that a penalty of between 50 and 75 basis points (.5% to .75%) resulted. Assuming a similar penalty on a $100 million Oregon Veterans' Bond sale (and at that volume the likelihood is that the penalty would be toward the upper end of the range), additional interest costs over the life of the issue would be between $11.2 and $16.8 million.* Under the best of circumstances a penalty of this magnitude would be cause for considerable concern. In today's market it is a potentially crippling blow to interest rate sensitive bonding programs.

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* Assumes a base interest rate of 12.5%, serial maturities over 25 years and level debt service payments.

Without spending too much time on the subject, I would like to outline a few developments of the past several months which, taken together, have had a dramatic effect on the municipal credit market. A large part of the problem is directly attributable to the current weakness in the nation's economy. As profits have declined among banks, life and casualty insurance companies (traditional mainstays of the municipal market), tax liabilities have diminished and the appeal of tax-exempt investments has waned. The market has weathered such economic cycles in the past, however, without undue difficulty. What makes the current situation unique is the combination of forces which are at work. A few of these are noted below:

* Increasing competition for a limited number of investor dollars. In the current market there are increasing numbers of tax-exempt issuers for non-conventional purposes. Foremost among these are private corporations issuing bonds though industrial revenue authorities (IRB). These firms often have an advantage over municipalities when competing for commercial bank interest, because the IRB purchase is viewed as a corporate client service by the bank -- and, as I have already noted, such banks have a limited and decreasing demand for tax-exempt holdings.

* Creation of new investment instruments which draw investor dollars away from traditional municipal note and bond markets. The recent creation of an "all-savers" certificate offered through banks and savings and loan institutions has drawn funds away from the debt instruments of municipal governments. At a time when the large institutional buyers are experiencing reduced profits and, therefore, reduced demand for tax-exempt investments, individuals have become the most single important component of the market. With the advent of the "all-savers" certificate individual buyers were given an

additional investment option -- one which competes directly with conventional short-term municipal instruments.

* Revisions of the federal tax code. Recent changes in the federal tax code have had the effect of reducing the attractiveness of tax-exempt investments. A reduced tax rate will unquestionably affect the appetite for such investments among individuals and institutions alike.

* Large-scale borrowing by the federal government. As recent reports from official sources begin to reflect the likelihood of much larger federal budget deficits than had been originally anticipated, the market must brace itself for a new round of large federal government financings. With uncertainty prevailing over the ultimate borrowing needs of the federal government, there is little hope for a sustained rally in the credit markets. All rates continue to be affected by the anticipated level of such borrowings.

Clearly the municipal market is currently experiencing some of the most difficult times in its history. There is increasing concern that municipal governments will no longer have access to the credit markets to finance essential projects and programs. The requirement that bonds be issued in registered form is yet another transaction cost which will be passed to municipal issuers at a time when they can least afford it.

I strongly urge you to pursue options to address the tax concerns associated with issuance of negotiable bonds which do not punish the municipal issuers. One such option might be to specifically require that tax-exempt interest earnings from municipal investments be reported on the federal income tax return. Another would be to require preparation of a separate schedule at the time the tax return is filed which lists all municipal holdings. Whatever course of action you choose, I hope that it results in punishment of those who use municipal investments for illegal purposes rather than the issuers themselves.

Thank you for the opportunity to comment on this matter of considerable importance to our state.

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October 30, 1981

The Honorable Robert Packwood
Chairman, Subcommitee on Taxation
and Debt Management
Committee on Finance
United States Senate
Washington, D.C. 20510

Re: Mortgage Revenue Bonds

Dear Senator Packwood:

On behalf of the Northeastern Retail Lumbermens Association, I would like to submit for the record the following statement with regard to the subject of your hearings of October 16, 1981.

The Northeastern Retail Lumbermens Association with offices in Wellesley, Massachusetts, and Rochester, New York, is a broad service-based trade association representing more than seventeen hundred retail lumber and building materials firms and building material wholesalers and manufacturers throughout New York State and New England. Our membership is on the "frontline" of the housing industry of this country and is perhaps uniquely qualified to assess its vitality in the New York and New England region. It is the consensus of my membership that housing is in deep trouble. A comparison of starts in our region between August, 1981, and August, 1980, shows a 23% decline. We see no brighter picture in the immediate future. Other people have supplied your Subcommittee with detailed statistical analysis of the need for housing and of the amountbeing produced. We will not repeat these figures but only confirm them from our individual experiences.

Probably the greatest single factor inhibiting production of housing in this country today is a lack of mortgage money at a cost which can be afforded by the great bulk of our population. One technique to deal with this problem is a tax-exempt mortgage revenue bond. This is essentially a local option, since by virtue of the legal necessities of such an issue, the decision whether or not

Serving Retail Lumber and Building Materials Dealers in the Northeast

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January 4, 5, 6, 7, 1981
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to go forward with a mortgage revenue bond program is one which is made close to the actual need for housing. It is not made in some far distant seat of government, but is, rather directly related to the public purposes of the area involved.

In some ways, we applauded the introduction of the original mortgage revenue bond legislation in April, 1979. There were abuses which had to be dealt with. However, when the legislation to deal with those abuses was subsequently enacted, we are sure that the Congress intended that the program it designed should work. It has not worked nor does it appear that it will work unless the issues dealt with by Senator Sasser in S.1348 and Senator Durenberger in S.1656 are corrected. We support both of these bills and urge their passage.

Our primary emphasis today lies in correcting the defects in the single-family home finance area. This position is partially based upon the fact that under present law, the tax exemption for single-family mortgage revenue bonds will expire December 31, 1983. Time is running out, but nothing is happening.

The issuance of this type of bond for mortgage finance was effectively suspended over two years ago when Representative Ullman introduced H.R.3712 in April, 1979. In December of 1980, the passage of the Omnibus Reconciliation Act seemed to reopen the possiblity of using the tax-free mechanism with certian specified limitations. However, it was not until July 1, 1981, almost seven months after the enactment of the bill and over two years from the date of the introduction of the original legislation, that regulations were issued for the single-family program. And the regulations as issued are unworkable, according to representatives of public issue groups.

The Reconciliation Act contemplated a loss of revenue to the Treasury over a three-year period in the area of $300 million. One of those years has gone by and the revenue loss must be practically zero since there has been, effectively, no program. Except for those issues which were in process at the time of enactment, there have been no more than a minimal number of issues brought to market. This "windfall" to the Treasury of nonloss of revenue might well be returned to the public in the form of an extension of the sunset provision. We urgently request that the Congress take action to start the program and suggest that the Sasser and Durenberger bills present reasonable solutions to the critical impediments between us and a useable source of mortgage funds.

I have mentioned the delay in the issuance of Treasury regulations. To date, there are no regulations at all with regard to the residential rental housing program. While tax exemption for apartment bonds is not facing the sunset provisions which relate to single-family mortgage revenue bonds, we urge this body and the Congress to correct the several issues dealt with by S.1656 by passing that bill at the earliest opportunity. We should not presume that clarifying regulations will be forthcoming. Treasury's lack of priority is well documented by its performance in the single-family area. Inquiry by the members of this Subcommittee may well be required before regulations are issued.

While our members are clearly profit oriented, it is also true that the residents of our region need the housing. There is an acute shortage of rental units. This, as always, is particularly true for those of low and moderate income. The Section 8 program of the Department of Housing and Urban Development is inadequate. In addition, the statements of the present Administration suggest that it is a dying program. Something must take its place, and that vehicle must be production oriented. A tax exempt bond can accomplish this in part, although we concede that some tenants will need more assistance.

There are currently studies which suggest that the presence or absence of a rental housing shortage is a local condition. While I express no opinion with regard to the accuracy of that theory, I point out again that the issuance of a mortgage revenue bond is a decision that is made by those who are close to the scene and who are familiar with the needs of the community involved. There is a great consistency between these two facts and it should not be forgotten.

In conclusion, the Northeastern Retail Lumbermens Association urges that the Congress take whatever action is necessary to ensure that the issuance of tax-free mortgage revenue bonds for both single-family and multifamily housing becomes again an effective part of our housing strategy.

Thank you for your courtesy in receiving this statement.

Sincerely,

Horace Pierce

Horace G. Pierce
Executive Vice President

TESTIMONY BY WALTER L. BENNING, PRESIDENT, MANUFACTURED HOUSING INSTITUTE, BEFORE THE SENATE FINANCE COMMITTEE

My name is Walter Benning and I am president of the Manufactured Housing Institute, Inc. ("MHI") which is the national trade association for mobile home manufacturers and suppliers engaged in the production and servicing of mobile homes.

There are an estimated 178 mobile home manufacturers in the United States, with approximately 470 manufacturing facilities. In 1980 these manufacturers distributed over 221,000 homes to the continental United States and Alaska. MHI represents more than 70% of this production capability for manufactured housing.

It is vitally important for our lower income Americans that this needed source of mortgage funds be made to work as the Congress intended.

As a result of cost consciousness of the mobile home industry in 1980, while less than twenty-five percent (25%) of site-built houses sold were priced under fifty thousand dollars ($50,000), virtually all of the manufactured homes sold during that same period were sold under that amount.[1] More recent data from the U.S. Department of Commerce indicates that in 1980 the average cost of mobile homes was $19,200 compared to the average price of a site-built home of $76,300.[2]

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[1] U.S. Department of Commerce, Bureau of Census, Data for Conventional Homes-Construction Reports (C-25-75-13; C-25-76-12).

[2] U.S. Department of Commerce, Bureau of Census, Housing Starts Construction Reports, April 1981, C-20-81-2; Price Index of New One-Family Housing Sold, April 1980 (C-2-7-79-Q4).

I. BACKGROUND

I am here today to testify concerning certain bills the Senate Finance Committee (the "Committee") concerning the Mortgage Bond Subsidy Tax Act of 1980, namely, S.1348 and S.1656 to clarify certain amendments which apply to mortgage subsidy bonds.

We are testifying today for two important reasons. The first is to add the support of our organization to the urgency that will be expressed to this Committee to provide a viable source of long-term mortgage money for housing the American people. I know that the decline in housing put in place in the last twelve months and the far-reaching efforts that such decline makes in all related industries is by now well known to this Committee. But what may not be well known to you is that the manufactured housing industry accounts for over 80% of all housing sold for under $35,000 per house today. MHI believes that any regulations which are promulgated for the issuance of tax-exempt bonds for the purchase of home mortgages under the authority of the Mortgage Subsidy Bond Tax Act of 1980 (the "Act") by the Internal Revenue Service ("IRS") should reflect the fact that mobile homes, based on current design and construction, merit the same treatment as any other type of housing built to recognized codes and accepted by state and local authorities as single-family housing. It is important that the Committee recognize that mobile homes built to comply with the U.S. Department of Housing & Urban Development's Federal Construction and Safety Standards (Appendix A attached hereto) are equal to conventional site-built homes in terms of safety, quality and durability. Moreover, when placed on permanent foundations not only the appearance of mobile homes but also the construction quality are indistinguishable from that of conventional, site-built homes of comparable size.

MHI feels it would be helpful to the Committee in considering the above Senate bills to address generally the present state-of-the-art of the mobile home industry with respect to the quality, safety, durability and cost of manufactured housing as compared to site-built housing.

II. MOBILE HOMES COMPARED TO CONVENTIONAL SITE-BUILT HOMES.

In 1974 Congress, pursuant to the National Mobile Home Construction and Safety Standards Act of 1974, delegated to the Department of Housing and Urban Development ("HUD") the responsibility for promulgating a complete mobile home housing code and an enforcement system extending from the first stage of production to the consumer's use as a home. In accordance with this Congressional mandate, HUD developed the Federal Mobile Home Construction and Safety Standards, initiated research to improve these standards, and implemented a comprehensive enforcement system. On December 18, 1975 HUD published as final the Federal Mobile Home Construction and Safety Standards, 24 CFR Part 3280 (the "HUD Code"), which govern the design and construction of mobile homes. On May 13, 1976 HUD published the Mobile Homes Procedural and Enforcement Regulations, 24 CFR Part 3282, which implement HUD's responsibilities to develop a comprehensive enforcement system to ensure compliance with the standards, and to assure that consumer complaints are adequately handled.

The Federal Mobile Home Program is comprised of an entire network of organizations to assure conformance to the HUD Code. There are 35 state agencies approved by HUD to oversee manufacturers' handling of consumer complaints and "recalls" of certain defective mobile homes.

Manufacturers contract with third-party engineering firms (both state and private agencies) known as primary inspection agencies (PIAs). HUD has also contracted with the National Conference of States on Building Codes and Standards (NCSBCS) to monitor all PIAs in their performance of design reviews and plant inspections. To advise HUD on standards development and enforcement, HUD convenes the National Mobile Home Advisory Council twice a year. This Council consists of 24 representatives, evenly balanced among three groups -- consumers, industry and state officials.

A. The Hud Code is Comprehensive.

The HUD housing code for mobile homes is unique in the housing industry. There is no such mandatory Federal code and enforcement system for any other type of housing. In fact, modular homes which are built under the same manufacturing process and often cannot be distinguished from mobile homes have no such regulatory oversight and have typically been treated differently than mobile homes for purposes of state and Federal regulation.

The purpose of the Mobile Home Act is set forth by the Congress in the preamble to the Act, as follows:

> "The Congress declares that the purposes of this title are to reduce the number of personal injuries and deaths and the amount of insurance costs and property damage resulting from mobile home accidents and to improve the quality and durability of mobile homes." 42 USC §5401. (Emphasis added.)

Therefore, the focus of the HUD Mobile Home Act is on quality and durability of mobile homes, as well as on safety. Pursuant to this stated purpose, Congress required HUD to establish "mobile home construction and safety standards." 42 USC §5403(a). These standards relate not only to safety but also construction, and constitute a complete mobile home housing code found at 24 CFR Part 3280 of the HUD Regulations. The comprehensive nature of the HUD Mobile Home Standards is reflected in the Code's subparts which address:

- Fire Safety;
- Body and Frame Construction Requirements;
- Testing;
- Thermal Protection;
- Plumbing Systems;
- Heating, Cooling and Fuel Burning Systems;
- Electrical Systems; and
- Transportation.

Moreover, the regulation states that:

> "This standard covers all equipment and installations in the design, construction, fire safety, plumbing, heat-producing and electrical systems of mobile homes which are designed to be used as dwelling units." 24 CFR 3280.1.

Title 24, Section 3280 of the Code of Federal Regulations ("CFR"), incorporates by reference not only existing standards and codes of agences of the United States Government, but reference standards which are the identical construction standards used in production of housing on-site. Mobile homes also adhere to standards set forth in nationally accepted gas, mechanical, plumbing and electrical codes.

The most impressive summary of the current state-of-the-art in mobile home design and construction was made by Dr. Arthur Bernhardt,[3/] in his report for HUD, who stated:

> "The mobile home from an engineering point of view is a more sophisticated structure than the conventional home. It is engineered to satisfy the same loading conditions of a conventional home while selling at a fraction of the cost. At the same time, it must meet the greater, sharper and unpredictable dynamic conditions caused by over-the-road movement.
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> * * *
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> "The claim that the mobile home is of interior construction is not justified. The basis of this claim is caused by a one-to-one comparison of structural members in a conventional home and

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3/ This five-volume, 5,000 page reported contracted for by the Department of Housing and Urban Development is considered to be the most comprehensive study of the mobile home industry to date. The results of this report have been condensed in Dr. Arthur Bernhardt's book, "Building Tomorrow: The Mobile/Manufactured Housing Industry," published March 15, 1978, MIT Press, Cambridge, Massachusetts, and London, England.

> and a mobile home. Such a comparison, however, is meaningless because of the difference in structure design principles used. Mobile home design principles are more efficient than those used in the structural design of the conventional home." [Unpublished study for the U.S. Department of Housing and Urban Development.] "Manufacturing," pp. 86, 93.

The prosaic definition of "mobile home" set forth by the United States Contress in the National Mobile Home Construction and Safety Standards Act of 1974, 42 USC §5401, et seq. (Appendix B), understated the significance of that statute which formally elevated mobile homes to the equivalent of single-family dwellings manufactured to building codes such as those of the Building Officials and Code Administrators (BOCA), International Conference of Building Officials (ICBO), and the minimum property standards, or other local codes. Appendices C, D and E are indicative of the specifications covered by the Federal standards and the other codes. These comparisons between the Federal standards and other codes reveal how minor the differences are.

B. Fire Safety.

The fire safety record of mobile homes of all ages is equivalent to that of conventional site-built homes, while the safety records of mobile homes built in accordance with the National Mobile Home Construction and Safety Standards Act of 1974 are superior to site-built homes. Moreover, the fire safety requirements of the HUD Act exceed those for conventional homes and have served to significantly reduce the deaths, injuries and property losses from fires.

Based on 1978 data in the National Fire Incident Reporting System ("NFIRS"), a recent analysis prepared for MHI by Howard Gates entitled "Comparison of Fire Risk in Mobile Homes and Site-Built Houses" indicates that the incidence of fires for all mobile homes was 534.045 per 100,000 mobile homes, compared to 534.5 per 100,000 for all site-built homes. Although the fire incidence rate for all mobile homes is fractionally less than the fire incidence rate for all site-built homes, the study reported that the fire incidence rate for mobile homes dropped significantly to 379.9 per 100,000 for mobile homes built after implementation of the HUD Act of 1976. A detailed report for the State of California also bears out this conclusion. (See Appendix E.)

C. Wind Stability.

Subpart D of the HUD Mobile Home Construction and Safety Standards (Appendix A, §280.301) covers the minimum requirements for materials, products, equipment and workmanship needed to assure that the mobile home will provide structural strength and rigidity, protection against hazard of windstorms, resistance to the elements, and durability and economy of maintenance.

This subpart provides requirements for mobile homes located in two different wind zones: standard wind (zone 1) requires that "the mobile home and each wind resisting part and portion thereof shall be designed for horizontal wind loads not less than 15 psf and a net wind upload of 9 psf"; and hurricane resistance (zone 2), which requires that: "(i) when a mobile home is designated as 'hurricance resistive' the home and each resisting part and portion thereof shall be designed for horizontal wind loads of not less than 25 psf and a net wind uplift of not less than 15 psf." (§280.305 (c)(1) and (2) of the HUD Standards.)

In addition, to the requirements of 24 CFR Part 280, Section 280.305, Section 280.306 -- Wind Storm Protection -- requires that: "each mobile home shall have provisions for support for anchoring which, when properly designed or installed, will resist overturn and lateral movement (sliding) of the mobile home as imposed by the design loads." This section also requires that the manufacturer provide printed instructions for each mobile home, specifying the location and required capacity of stabilizing devices.

D. Warranty Service and Consumer Protection.

Mobile home warranty service has improved significantly since the early 1970s as a result of: (1) promulgation of the National Mobile Home Construction and Safety Standards Act of 1974 (42 USC §5401); (2) adoption of the Magnuson-Moss Warranty Act (15 USC §2301) which provides disclosure requirements for consumer warranties; and (3) the myriad of state legislation relating to manufacturer, dealer licensing and bonding, installation and tie-down, and mobile home warranties.

The problems and defects in mobile homes are no different than problems and defects that occur in conventional homes. Unlike conventional homes, however, almost all manufacturers of mobile homes provide warranties, and mobile homes are subject to Federal regulation under the HUD Act.

Mobile home owners have remedies under the HUD Act which require correction of major construction defects vitally affecting the use of the home. The HUD correction requirements extend throughout the lifetime of the mobile home; they are not limited to the ten years provided for under the New Home Warranty and Builders Registration Act.

The HUD regulations have significantly increased mobile home soundness, not only through the extensive requirements of the construction and safety standards, but through HUD's elaborate inspection system set up to monitory quality control. HUD's consumer complaint handling mechanism furthermore provides for notification and correction of defects in mobile homes after they leave the factory. HUD has consistently rejected every attempt to downgrade the HUD standard and to allow manufacturers to produce mobile homes which are not in accordance with the letter and intent of the HUD Act.

In response to a request by a recreational vehicle manufacturers to clarify the difference between large recreational vehicles and small mobile homes, HUD has solicited by publication in the Federal Register (Docket #R80786, 4/21/80 at p. 26906) the comments of those who have an interest in this narrow area between large recreational vehicles which can be used for permanent dwellings and small mobile homes. The mobile home industry has recommended that the HUD Code not be relaxed in any of its standards or specifications as they apply to small mobile homes or large recreational vehicles. It is anticipated that HUD will continue to insist that permanent dwellings will be subject to the HUD standards and the careful solicitation of public comment by HUD in the Federal Register bears out this opinion.

E. Cost and Financing.

Current Federal and state policies relating to financing and taxation have changed significantly in the last several years due to the impact of the HUD standards on the quality, safety and durability of mobile homes.

1. Cost.

Because of production efficiency, mobile home costs have remained affordable and available to low and moderate income families. Prices have been tailored to those who can afford to buy. In addition, mobile homes come fully equipped with furniture and major appliances. MHI estimates that approximately 250 man hours are required to build a mobile home on a production line which runs as long as required, and which is impervious to the weather. The net result is that the average sales price in 1973 of a mobile home was $7,770 at a cost of

$8.84 per square foot, compared to an average sales price of $35,500 for site-built homes at $17.60 per square foot. By 1980, the average cost per square foot for a mobile home had increased to $17.80 while site-built homes had risen to $36.00 per square foot. For further analysis of these figures, see Appendix G, MHI's June 1981 issue of "Quick Facts," a summary of industry statistics.

The net result of the cost consciousness of the mobile home industry was that, in 1980, while less than twenty-five percent (25%) of site-built houses sold were priced under fifty thousand dollars ($50,000) virtually all of the manufactured homes sold during that same period were sold under that amount according to statistics published by the United States Bureau of Census, Construction Reports (Series C-25, New One-Family Homes Sold and For Sale, February 1981), U.S. Dept. of Commerce, 1981.

The Bureau of Census also reported in the Annual Housing Survey, 1979, Part A, that the median income of mobile home owner-occupied household heads was $11,700. Since 1977 the cost of site-built housing has risen at an alarming pace. The picture is very clear, therefore, that mobile homes manufactured in factories are the only affordable housing for low and moderate income Americans.

2. Financing.

Symptomatic of the change in the United States Government's attitude towards mobile homes have been the actions of Congress and agencies, such as HUD, the Federal Housing

Administration, and the Veterans Administration, to facilitate their sale.

In order to make the mobile home industry a more readily available source of low-cost housing, the Federal Government initiated loan insurance and guarantee programs through the Federal Housing Administration ("FHA") and the Veterans Administration ("VA"). The objective of these programs was to reduce the financing costs for mobile home purchasers, primarily by lowering interest rates, lengthening contract terms, and allevaiting costly credit insurance policies. In the VA and FHA programs, the lender is induced to make mobile home loans at the lower specified interest rates, lower downpayments and longer maturities, because Government agencies underwrite the risk. These policies have reduced risks to the lender and have served to narrow the gap between the typical mobile home retail interest rate and the conventional home mortgage rate. To further reduce interest rates for mobile home loans, the Federal Government has also authorized savings and loan associations to purchase mobile home mortgages, which increases lender competition.

On August 20, 1981 the Federal National Mortgage Association issued regulations to authorize the purchase of mobile home loan mortgages with maturities up to thirty years from all FNMA Sellers, a clear recognition of the structural soundness and long life of the mobile home The liberalization of credit terms is a direct reflection of the fact that mobile homes are now perceived as permanent housing when affixed to real property. In recognition of the importance of mobile homes as affordable housing, the Federal Government in October 1979 allowed a display of mobile homes on United States' property on the Mall at Washington, D.C., for examination by the Congress, its staff and the Federal agencies involved in the housing industry. (Appendix K.)

The Housing and Community Development Amendments of 1980 to the National Housing Act were enacted by both Houses of Congress at the end of December 1980. A survey of the terms approved in that Act, for FHA-insured mortgage loans, shows that mobile home buyers receive the benefit of credit terms comparable to site-built housing, despite the difference in costs, including loans up to $36,500 for 25 years with 5% downpayments.

The Veterans Administration guarantee program supports the mobile home industry with terms almost as liberal as those of the FHA.

The distinction by the Federal Government financing institutions between mobile homes and site-built housing of comparable size is swiftly diminishing.

3. Appreciation.

Although mobile homes built during earlier years were subject to significant depreciation, this situation has changed dramatically since the 1974 Act. Several factors which impact on the life of the mobile home have resulted in two phenomena: (1) mobile homes built during the 1960s which did depreciate during the early 1970s have recently increased in value -- in many cases beyond their original selling prices; and (2) mobile homes built recently are not only maintaining but increasing in value.

A recent report by Foremost Insurance Company, the largest insurer of mobile homes in the United States, sets forth the results of a study begun in June 1978 and a more recent study conducted in the first few months of 1979 to determine what had happened and what currently is happening to mobile home values. The samples for the research included approximately 500,000 homes for the establishment of new home prices and approximately 120,000 for used home values. The study reached the following conclusions relating to appreciation of mobile homes:

(1) the increasing expense and shortage of site-built housing is creating a demand for affordable housing which has contributed to the appreciation of mobile home values;

(2) mobile home depreciation in the past has been primarily a function of the minimal increase in the price of homes which averaged approximately $1,500 during the entire period of 1960 through early 1971. The increase in average value in new mobile homes shipped from 1972 through 1978 was approximately $10,000, or 143%. The increase in the value of new mobile homes has resulted in the value of older homes either remaining constant or moving upward.

(3) a 12' wide mobile home purchased in 1975 for $4,550 could be sold today for $6,050, or an overall increase in value of 32.3%, or roughly 5.3% per year.

(4) the dollar sales figures reflect a favorable appreciation rate for multi-sectionals which with few exceptions appear to appreciate from the initial sales date.

In the MIT study performed for HUD, Dr. Arthur Bernhardt reported that:

> ". . . extensive nationwide . . . interviews of traditional builders and developers, as well as mobile home manufacturers and park operators, suggest that the economic life of the mobile home is considerably longer than is commonly assumed and may be close to the life of a conventional home . . . the depreciation rates tend to vary by mobile home model and year of production. The characteristics cause the resale value of mobile homes to resemble that of automobiles in that prices are determined by age and Blue Book estimates rathar than by appraisal of the true value." (Building Tomorrow: The Mobile/Manufactured Housing Industry, supra, p. 310.) (Emphasis added.)

The so-called "Blue Book" values are not indicative of the true value or actual resale value of mobile homes built today. Mobile homes are no longer transportable from site to site, as were travel trailers in earlier years and should no longer be valued by the same method as automobiles. Mobile homes, rather, are housing built to standards equivalent to those of conventional homes, and should be appraised as such by conventional real estate appraisal methods used for site-built homes. (See Appendices H, I, J.)

With this background on manufactured housing in mind, I would like to review with you the comments on the bills before the Committee, Senate Bill 1348, and Senate Bill 1656.

Senate Bill 1348

Senate Bill 1348 provides for certain Amendments to the Mortgage Bond Tax Subsidy Act of 1980 as follows:

(1) Good Faith Compliance (Subparagraph B, Section 103A (c)(2)).

The proposed changes would provide for recognition of good faith compliance by an issue as set forth in Section 103A(c)(2) provided such technical errors were corrected within a reasonable time period.

We support this change as being within the spirit and extent of the statute, and preventing inadvertent disqualification because of technical errors made in good faith.

(2) Reliance on Covenant (Paragraph (2), Section 103A(c)).

This follows in natural consequence to the above section, and protests a subsequent Holder of the security from inadvertent disqualification during the period an issue may require time to correct technical errors within the authority outlined above, and we fully support this change.

(3) Ownership Interest (Paragraph 1, Section 103A(c)).

This section provides eligibility to proceeds of an issue for mortgagors whose homes in the previous three-year period may not have met certain minimum property standards, or suffered a natural disaster, or did not have a present ownership in such mortgagor. These sections recognize certain cases in which the three-year limitation causes undue hardship cases and we again fully support that recognition.

(4) Purchase Price Requirements (Paragraph (2)(3), Section 103A(f)).

This change in paragraphs (2) and (3) of section 103A(f) relating to purchase price requirements for residences financed with proceeds of an eligible mortgage bond issue defines the "average area purchase price" qualification. Paragraph (3) states the determination of average purchase price need not include residences which are not typically financed through a normal real estate mortgage loan (such as with residences to be located on land occupied under a lease having a term less than 15 years or a residence which is normally financed as personal property).

Such language recognizes that many mobile home loans are considered loans on personal property. Because over eighty percent of all homes costing $35,000 or under are mobile homes to the extent they are included in the overall "average" area purchase price calculation" they would therefore decrease the price calculation. We do support this change to accommodate this type of calculation, but we feel that it should be made clear that, in any event, all mobile home loans for real property loans or personal property loans should be eligible for funding from the proceeds of such issues. We would recommend therefore that such eligibility be made clear by inserting the following language: "although, in any event, residences financed by personal property loans are eligible for financing under this section".

(5) Effective Mortgage Rate and Yield Computations Section 103A)(2) and (IV) Section 103A(a)(2)(B)).

We support the changes contained in this section to increase the effective rate of interest for mortgages under this issue over the yield, and the effective interest of yield as vitally necessary to attract investors into the marketplace to purchase such issues. In the light of historic rise in interest rates and unprecedented computation for rate and yield, we view these changes are necessary features for the competition by such mortgage bonds in the marketplace.

(6) Assumptions (3103A(j)).

We also support the changes specified in the sections relating to conditions for assumptions as to owner-occupied homes, and those insured by the Federal Housing Administration or guaranteed by the Veterans Administration.

Section 1656.

As to Senate Bill Section 1656, we reaffirm our support of the good faith compliance section set forth in this Bill, as included in our discussion of Section 1348.

As to the section for increase in accounting mortgage interest rates, we find that the computation for such long-term money is so severe at the present time in the long-term money markets, that greater flexibility than one and one-quarter percent contained in this Bill will be needed.

Of particular interest to us in Senate Bill 1656 is the section authorizing Industrial Development Bonds for certain residential rented property. We feel that rental mobile homes fit the financial requirements for low-cost rental housing units contemplated by this section and deserve close attention by the Committee.

LIST OF APPENDICES

A. Federal Construction & Safety Standards, 24 CFR Sec. 3280.

B. 42 USC §5401, National Mobile Home Construction & Safety Standards Act of 1974.

C. A Comparison Between HUD's Mobile Home Construction & Safety Standards (1978) and BOCA's Single-Family Dwelling Code (1975), Manufactured Housing Institute, Inc.

D. Comparison of Design Criteria for Single-Family Dwelling, Federal Mobile Home Standard and Uniform Building Code.

E. Draft Report from Xavier Mendoza, Acting Chief, Division of Code & Standards, to California Commission of Housing & Community Development, February 14, 1977.

F. Comparison of Fire Risk in Mobile Homes and Site-Built Houses (Draft) by Howard P. Gates, consultant, June 7, 1980.

G. July 1980, Quick Facts, Manufactured Housing Institute, Inc. publication.

H. Fig. 1 - Photograph of Mobile Home in 1950s.

Fig. 2 - Photograph of Current Single-Section Home.

Fig. 3 - Photograph of Current Double-Section Home.

Fig. 4 - Photograph of Current Double-Section Home.

I. Fig. 1 - Photograph of Early Mobile Home Park.

Fig. 2 - Photograph of Present-Day Mobile Home Park.

J. A Properly Sited and Landscaped Mobile Home.

K. Figs. 1, 2, 3 and 4 - Photographs of Mobile Homes Installed on the Mall, Washington, D.C., October 19-20, 1979.